CAZENOVE
CAPITAL MANAGEMENT

CHARITY INVESTMENT ANNUAL 2015

Charity Investment from Schroders

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Welcome

In this annual we pull together a collection of interesting articles that we believe are useful reading for long term charity investors. We capture some of the best 'new' ideas and cover updates in legal and investment thinking that may be relevant to the management of your charitable assets.

Giles Neville
Head of Charities

Contents

Time is an asset 2

David Emerson, Chief Executive, Association of Charitable Foundations

Lessons from the last 40 years for the next 20 5

Alan Brown, Governor, The Wellcome Trust and formerly Senior Adviser, Schroders

Regulatory update

Total Return for Permanent Endowments **11**

Cazenove Charities

A new social investment power for charity trustees? **12**

Hannah Kubie, Stone King

A Wellcome perspective **14**

Danny Truell speaks at the inaugural Cazenove Charities lecture

Report by Andrew Sheaf, Portfolio Director, Cazenove Charities

Musings from the desk **16**

A collection of articles from Cazenove Charities published in the sector press in 2014

Kate Rogers, Head of Policy, Cazenove Charities

In defence of the active manager | Where has all of the money gone?
Is volatility risk? | To spend or to save?

Time is an asset

David Emerson
Chief Executive, Association of Charitable Foundations (ACF)

David Emerson gave the opening speech at the ACF Annual Conference in November 2014, focusing on how charity foundations can use time as an asset.

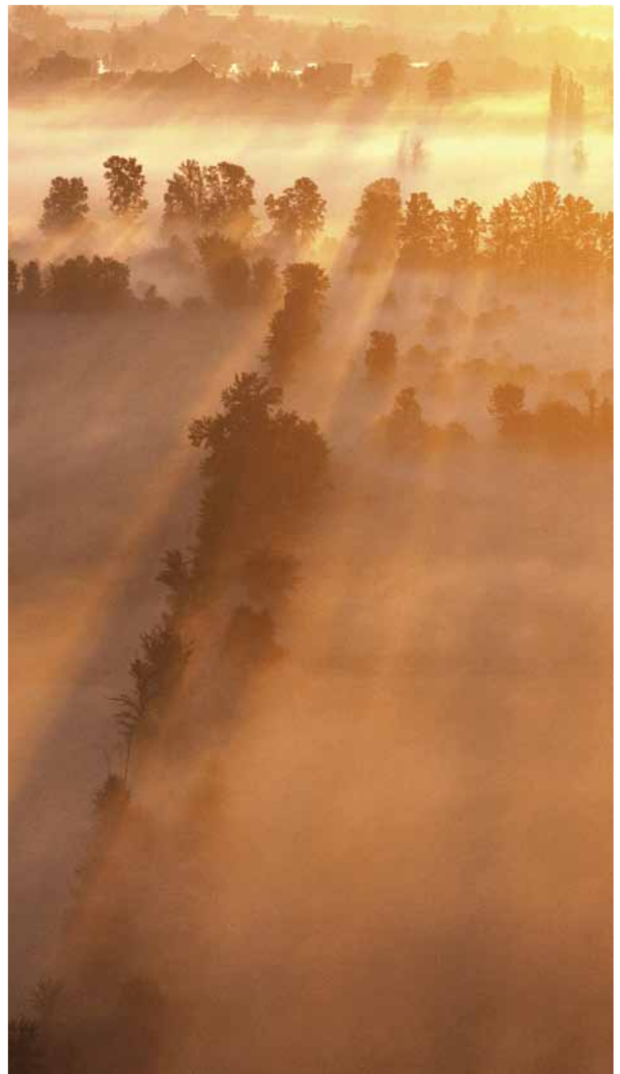
"Time. We don't think about it much; time-keeping yes, but not just 'time'. Perhaps because we live and move in it; it's too obvious. But ACF's 25th Anniversary has led us to think not only about our past, but what may be our - and your - future too. There is of course, no such thing as a certain future. But we have been thinking that, because of your ongoing income, as foundations your own future existence is more certain than most, and that means you have time at your disposal, as well as money.

My question to you then is: as 'keepers of time' can you think of the time you have as another asset and one that you can also deploy with intention?

What do I mean by this? Well, in contrast to Government and business - who are driven by election and market cycles - for those with endowments there is a growing awareness that over the long-term such investments provide a secure source of income which few others have. Indeed, our own research last year demonstrated that charity investors with the greatest sense of what the long-term was, generally felt able to spend at higher rates than those who thought in shorter time periods.

They are able to do that because taking a long-term approach to the stewardship of their endowments gives them the confidence to ride out short-term market volatilities. So time can give us confidence.

But whether you are endowed or not, (and our research shows that ¾ of ACF members rely on investment returns to fund their activity) foundations have a strong expectation that - for the foreseeable future - their sources of revenue are probably more secure than others. It is this central expectation that is core to my argument



today, because it is this that means that foundations and endowments experience time differently from others, who have to work within defined periods of time, or depend on continual fund-raising, or on trading activity, to survive.

As evidence of just how much of a difference that makes, we have at least three members whose creation pre-dates Magna Carta - that is to inhabit time very differently indeed from other organisations in society. Few other entities have survived that long.

> "Can you think of the time you have as another asset and one that you can also deploy with intention?"

So, if we do inhabit time differently, can we then deploy the 'time' we have to good effect? We certainly think so. Foremost, being unconstrained by the often artificial time periods of others means that we can direct all our attention and all our activity to the mission - no matter how long it takes to see it through or who else comes or goes. That is a very significant difference. I have in mind here the sort of commitment that some ACF members made in supporting delicate, peace building initiatives in Northern Ireland during long years of conflict when there was no foreseeable end in sight. Now of course, that is partly a story about foundations using their independence to support causes that others shy away from. But it is profoundly also an illustration of foundations committing not just money but time to a problem - in order to see it through and make a difference.

Because you have time you can make a spending commitment of say 10, or 20 years to address an issue, and know that you can see it through. This as a commitment no-one else, and certainly not Government and business, can make. How significant an asset could, or even perhaps should, that be towards tackling deep seated societal problems? This insight frames the Wellcome Trust's commitment in 2010 to a 10 year Strategic Plan to 'Reflect the long-term view we take in supporting research, and the complex and global nature of the challenges we face'.

I quote this to emphasise that what I'm talking about is not something that foundations and endowments aren't doing already; I have often heard some of you refer to 'planning grants' you have made to enable prospective applicants to have the time to develop an idea. So as well as being trailblazers, foundations are:

- the patient ones
- the committed ones
- the ones who remain when others give up, and
- the ones who get stuck in when others feel it is just too time consuming.

What I'm trying to suggest, then, is that we allow 'time' to take shape for us; so that it gathers within in our hands, and becomes a very tangible tool we can use with intention. Foundations hold assets in order to benefit others, and our argument today is that time is no exception. It is another asset we have to give, one that allows organisations to:

- develop their ideas
- deepen their responses, and, crucially,
- to plan for their own futures.

It was the Institute for Voluntary Action Research report last year that found that for small and medium sized organisations struggling to survive; 'time to reflect & plan' was what they most lacked.

But time is also an asset for you. We can think about what foundations can gain over time: knowledge, networks, reputation and trusted partnerships, amongst others. So thinking about time can remind us of how we are maximising our own knowledge and working relationships so that perhaps we appreciate fully assets such as these, and which new entrants to the philanthropy world quickly discover they need just as much as money if they are also to make a lasting difference. In addition I would argue here that it is the institutions of philanthropy, namely foundations, which are most able to deploy time effectively, and well beyond that of most other philanthropy operators. Foundations therefore can grant time and deploy its fruits as a distinctive aspect of their activity.

On another tack, we might think of social investment. When the going gets really tough for ambitious social entrepreneurs, it could be that foundations may be the only investors who can meaningfully put the 'patient' into what is known as patient capital; i.e. the repayable funding that organisations use to start up or grow.

Foundations' possession of time therefore, has real consequences for the way they work, and for the causes they can support: heritage, the arts, the environment, and conservation. Equally, alongside social causes these all require time, commitment and continuity; and foundations are one of the few organisations able and willing to take the long-term view required to ensure that today's social goods are available to tomorrow's generations.

Being able to take that long-term view is also a corrective to the short-term news agenda that's influenced by what's trending on Twitter. Although in thinking about that, I'm reminded of Zhou Enlai's famous response in 1972 when asked about the impact of the French Revolution: "Too early to say"; a witticism that perhaps could now be an element of our own impact assessments?

We may not see ourselves sitting so remotely to social change as comrade Zhou, but I do suggest that one of the downsides of continual public service reform may be that the public sector - and even Government itself - risks losing its institutional memory. Foundations may not have the biggest budgets but, with better staff retention and longer trustee tenures than most bodies, they may have the longest memories.

Looking to the future

The benefit for foundations of having a more secure existence is that it gives you the ability to operate precisely in areas where the immediate impact of change is uncertain, or where it will take many years before we can make a full assessment. Amid increasing calls for all funders to account very concretely for their impact, I suggest that because you have time you can take a discerning approach to the issue; you can place as much emphasis on learning from experience as proving your short-term success; and you can operate in the territory of 'don't know' for longer than others: you can build evidence bases over years; and fund longitudinal studies that take generations to yield results. Because you know you have a future, you have the freedom to redefine what success is, when long experience proves that something quite new is required; and you can wait patiently for the opportune time to act.

So this is our challenge to you: How do you take full advantage of the time that you have at your disposal? I hope to hear your thoughts, experiences and reflections. But let me close with a final thought.

We inhabit time, not eternity. The question I have been posing is how we might inhabit it. In posing it however, I have been conscious that I am not addressing a gathering of immortals - unchanged through the ages! Instead, those institutions represented by you here today, and which have survived the centuries, have done so because they have adapted, and adapted again, and again. If we want time to be our side, then we must make change our friend, or the future will greet us as an enemy.

Foundation trustees rightly see themselves as the guardians of today's assets for tomorrow's generations. Preserving things as they are is always a temptation. But even those whose mission is conservation know that environments and demographics change: conservation requires creativity; imagination; and adaptation. As Cardinal Henry Newman, the Victorian reformer author of the text of Gerontius, wrote: 'To live is to change, and to be perfect is to have changed often'.

Remaining as we are is not a realistic option for us so we must not expect to coast through the centuries. Instead we must remain alert, and constantly questioning ourselves:

Are we making the most of all that we have, in order to support those who are most vulnerable to the changes and chances of the world in which we live?

David Emerson is Chief Executive of the Association of Charitable Foundations (ACF). This article is an adapted version of his opening speech to the ACF conference in late 2014.

The Association of Charitable Foundations (ACF) is the membership association for foundations and grant-making charities in the UK. For 25 years ACF have supported trusts and foundations; respecting and safeguarding their independence, and helping them to be effective in the many ways that they use their resources. www.acf.org.uk

Lessons from the last 40 years for the next 20

Alan Brown
Governor, The Wellcome Trust; formerly Senior Adviser, Schroders

Introduction

In place of my usual Crystal Ball looking at the year ahead, I want to take a longer perspective and think about the lessons we can take from the last 40 years. The period from the end of the 1973/74 bear market, through the Great Financial Crisis to the present day, encompassed not only widely different market conditions but also a period of rapid development in the asset management business. It also happens to span my career in the City. As I reflect on this extraordinary period (or is it?), I do believe there are a number of lasting lessons we should take on board to help guide us through the next 20 years.

- During this time there have been many completely unforecastable events and developments. How should we respond to the unexpected?
- There have also been developments we could foresee with reasonable certainty. How should we respond to those?
- Time and time again we are reminded of the obvious. The best predictor of future returns is the price we pay for an asset! How can we control our many natural behavioural biases so that we do actually buy low and sell high?
- Our understanding of risk has developed a great deal. Volatility is not in my view the best measure of risk. Indeed volatility can present opportunity. Importantly volatility presents different issues for different types of investors.
- We are often guilty of making things too simple, and at other times too complex! It is important to understand the difference. Time-weighted returns are simple but can often mislead us, and regulation has a nasty habit of producing complex unintended consequences that drive us to be pro-cyclical. We had all better understand that.
- Finally, as an industry we can organise ourselves better. There is a great opportunity for those who are ready and willing to grab it, whether as an asset owner, asset manager or consultant. We can deliver better outcomes.

Expect the unexpected

Are you ever surprised by coincidences? Well, you shouldn't be! A world without coincidences would be a very strange place indeed. While any one coincidence may surprise or even delight, we should really worry if there were none at all.

> "It may be a statement of the obvious, but it seems to be one that we often forget. The best indicator of future returns is valuation"

The same is true of the unexpected. Unforecastable events happen all the time. As an investor we need to recognise that. We should all be quite humble about our ability to predict. I am not just talking about political or geological events such as 9/11 or the Indian Ocean Tsunami that caused so much devastation in 2004. Disruptive technologies, which almost by their name come out of left field and surprise us, can have a huge impact. In the late '60s and early '70s the concept of the Nifty Fifty was prevalent. These were stable, large cap stocks that you could 'depend' on. You could buy them and put them in the drawer and forget about them, or could you? By what hubris did we imagine that we had any idea what the competitive landscape would be like for Kodak and

Xerox just a couple of decades later? In fact, if you look at the constituents of the S&P500, only three of the top ten in 1980 were still present by 2013, and two of them by merger!

One event had a particularly profound impact on the investment industry and was not well anticipated. Strictly it does not qualify as an unexpected development as it was in fact predicted by Gordon E. Moore, founder of Intel, in his 1965 paper. Moore's law predicted that computing capabilities would double approximately every two years. At the time, he was referring to the number of transistors on a chip. More generally, it is now interpreted as meaning that speeds and memory will double every two years while prices will halve. This has really stood the test of time well.

Before joining the City, I worked as a physicist and used a Univac 1108 mainframe computer. The Univac 1108 was introduced in 1968. In most configurations it had 500 kilobytes of RAM (Random Access Memory) and it cost $1.68 million in 1968 money, about $11.5 million in today's money. My Apple iMac desktop at home has 4 gigabytes of RAM and costs about $2,500 in 2014 money. If you do the maths, that's exactly what Moore's law predicted. My Apple iMac comfortably sits on my desk. The Univac 1108 filled a room, a large room.

This exponential growth in computing power and affordability has had a profound impact on our industry. Not just in terms of the products and capabilities of the companies we invest in, but also on our own technology and understanding.

Harry Markowitz won the 1990 Nobel Prize for Economics for his pioneering work in Modern Portfolio Theory (MPT) first published in 1952 (Portfolio Selection). It was his work which introduced the concept of efficient portfolios where risk was defined as the volatility (standard deviation) of returns. An efficient portfolio was one which gave the highest return for a given level of risk. All this was well and good in theory but it was impossible to implement at the time as we simply did not have the computing power to handle the large scale matrices of returns, volatilities and correlations involved.

Roll the clock forward and Bill Sharpe, who also won a Nobel Prize for Economics in 1990, published his seminal paper describing the Capital Asset Pricing Model (CAPM) in 1964. The ideas set out finally made the concepts of Markowitz's work tractable. Sharpe made the entirely plausible assumption that return and risk were linearly correlated. After all why would an investor accept higher volatility if it was not compensated by higher return? In so doing the computational limitations of Markowitz model were overcome. Falling out of this work were two other conclusions. Returns should be IID (Independent and Identically Distributed) or follow a normal distribution. And crucially the market portfolio provided the highest possible return to risk ratio. It is hard to overstate the significance of this. It led to the start of the index, passive fund business when Wells Fargo launched the first fund in 1975. Since then trillions of dollars have been invested on this basis through passive funds and of course more recently through Exchange Traded Funds (ETFs).

What is important to remember is that almost all models are in some way approximations, or abstractions from reality. When Isaac Newton explained in one set of equations the movements of billiard balls and planets, in fact everything that was observable at the time, he had the humility in Principia Mathematica to acknowledge that if masses were too big or too small, or speeds too fast, his set of equations might not stand up.

That was pure genius! Move on to the 20th century and Albert Einstein developed the general theory of relativity for which he was awarded the Nobel Prize for Physics in 1921.

As Moore's law rolled forward not only did computing power grow exponentially but so did the data we had on stock prices and markets, so allowing us to test Bill Sharpe's assumptions. What we found was that:

– returns and volatility were not linearly related
– returns were not independent and distributions were not normal; they were leptokurtotic (fat tailed, high peaked).

Both of Bill Sharpe's key assumptions were wrong. That does not mean that the market portfolio is easy to beat. It isn't. We still have the truism that the return to all investors is the market return minus costs. Investors as a whole must earn less than the market.

The fact that returns are not normally distributed, but are instead fat tailed, means that we should expect outlier returns, tail events, to be far more common than we would expect from an efficient market as described by Markowitz and Sharpe, and that is exactly what we have experienced to our cost.

The growth in computing power and data is seductive. In 1974 the challenge was to get information. In 2014 the challenge is how to make sense of all the data we are bombarded with. Today the talk is all about Big Data. We are encouraged to believe that it holds the key to the universe. The reality is that too many of us misuse and abuse our computing power. If I measure the temperature in the room, and then repeat the measurement 1,000 times in the next minute, I am not likely to learn anything useful. More data is not necessarily more information.

Too many of us are seduced by the apparent sophistication of our models with the result that we put far too much reliance on them and their ability to give us precise answers. As a physicist I was always taught never to display answers to more significant figures than were significant! That is a lesson those of us working in investments would do well to bear in mind.

Expect the expected

While we are often surprised by the unexpected, we really shouldn't be surprised by the expected! By way of illustration, there are at least two fundamental developments (the reader may think of many more) that we should expect with a high degree of certainty, ageing demographics, and climate change.

I think everyone accepts that an ageing population in the developed world is baked in the cake for the next 40, 50 years or so. It does not take a rocket scientist to realise that this will have serious implications for our populations and place significant strains on our savings systems. It is self evident that all GDP is made only by our workers. To the extent that non-workers, children, unemployed and pensioners get to eat, there must be a transfer of income from workers to non-workers. As the dependency ratio deteriorates, the inter-generational strains grow. We are not powerless to do something about this and certainly in many countries there is an acknowledgement of the problem. We can see this in some of the policy shifts being made for example here in the UK in recent years, but it remains a tough sale to the electorate as many are deeply unpopular. It is not particularly controversial to introduce policies which increase female participation in the workforce, but it is if you seek to increase the age of retirement or otherwise degrade the pension promise. Immigration, another way to increase the work force, is an explosive issue.

The overwhelming majority of scientists believe that the climate is changing and human activity is having a significant effect. We should expect that this will lead to efforts to both mitigate and adapt to the problem. What does that mean? It means that our environment is likely to be stressed with disruptive weather patterns and potentially more droughts, floods and crop failures. In one form or another, businesses and individuals are likely to have to pay more for the externalities they create. It means that we should at least contemplate the possibility that stranded assets on energy company balance sheets may need to be written off.

But it isn't all negative. We should look out for the disruptive technologies that will help us mitigate or adapt. Ford has developed a 1.0 litre EcoBoost 3 cylinder petrol engine. It is about the size of a sheet of A4 paper and

delivers as much power as a 1.6 litre conventional engine while using 21% less fuel. We should celebrate these successes and indeed, as investors we should seek them out.

Remember the blinking obvious

It may be a statement of the obvious, but it seems to be one that we often forget. The best indicator of future returns is valuation. When prices are high, future returns are low, and vice versa!

Why is this? If we take equities, price to earnings (P/E) ratios are bounded. They cannot rise or fall for ever. So when P/E ratios are at extremes either the numerator or denominator must correct. Almost by definition, trend rates of growth don't change very often which means that more often than not P/E reversion happens through the price falling.

First though, there is another lesson from history we would do well to remember. What goes around, often comes around. Paradigms change. Over the years, we have seen Keynesian ideas give way to Monetarism and then swing back to Keynesian. Today there is an over-reliance on (unusual) monetary policy to fix our problems. It is almost as though once we settle on an instrument of policy it begins to lose its effectiveness. Perhaps that shouldn't surprise us. When Newton worked out how apples fell out of trees, we could be reasonably confident that they would continue to do so in the same way century after century. With financial relationships, that is not the case. As soon as a relationship is discovered it begins to be arbitraged away.

Lessons we (should) have learnt

I am reminded of the father who asks his child "What did you learn at school today?" Answer: "Apparently not enough. I have to go back tomorrow!" There is the old market adage that "in the short run we learn a lot; in the medium term we learn a little; but in the long run we learn nothing".

For my last Physics analogy, I call on Einstein who reputedly said "We should always make things as simple as we can … but no simpler!" We are definitely guilty of that!

Why do we think that standard deviation, or volatility, is in anyway an adequate description of risk? First, standard deviation treats upside risk the same as downside risk. In forty years in the business I have never met a client or a fund manager who believes that.

Another example of where we make things too simple is in our use of time-weighted returns. The asset management industry spends almost all of its time thinking about time-weighted returns (where the return in each period is given equal weight) as opposed to money-weighted returns where each return is weighted by the amount of money it acts on. Time-weighted returns are simple and convenient, but it is money-weighted returns that most matter to investors and the difference can be dramatic.

Behavioural biases

In my opinion, at the root of many of these issues lie behavioural biases which are almost hardcoded in our DNA. It is well documented that we are far too confident of our ability to predict the future. It is also clear every day that you read market reports that rising prices are 'good', and falling prices are 'bad'. Really? Not so fast. When we walk down the high street and see something we have always wanted offered 25% off in a Sale, we buy it and go home feeling good. But when we wake up in the morning to find that our favourite share or market is offered 25% cheaper, most of us feel sick to our stomach. Our gut instinct is to sell what we have, not buy more. That is very revealing, but why the different reaction to falling prices? If we were buying stocks for the good old fashioned reason of wishing to acquire growing dividend and earnings streams, surely the fact that we could buy them more cheaply would be good news. Instead what we are doing

is buying stocks in the hope of being able to sell them on at a higher price. So finding ourselves in a 25% hole is clearly bad news. We instinctively have a trader's mentality, not an investor's.

Helping our clients and ourselves resist this bias is probably the single most important thing an asset manager can do, and it is not easy.

Unintended regulatory consequences

Regulation is another area where we should not make things too simple. There can often be complex, unintended, and sometimes adverse consequences. Nothing did more to boost executive compensation than when disclosure requirements were increased. No company comes out and says that it plans to pay its Directors 3rd or 4th quartile compensation. They almost all come out and say they plan to pay 2nd quartile. That puts remorseless upward pressure on compensation, not perhaps the desired or contemplated result!

Andy Haldane from the Bank of England made a speech at the London Business School (April 2014) that regretted that the asset management industry failed to behave in a long-term, counter-cyclical manner during the Great Financial Crisis. He immediately acknowledged that regulation and accountancy rules made it very difficult indeed for this to happen. That brings me to my last topic.

The industry can do better

What do I mean when I say the industry is badly organised to deliver? It is always fun to blame the Americans. To that end, I point to a piece of legislation passed in 1974, ERISA, the Employee Retirement Income Security Act. It was this Act that spawned the investment consultancy business and led to the benchmark based best practice model that is pretty much standard today, but not I hope for much longer.

What then is the best practice model I so dislike? It is essentially a five stage process:

1. Determine a strategic, market based benchmark
2. Construct an implementation plan around that benchmark
3. Conduct a manager search to fulfil the implementation plan
4. Fund and monitor the managers
5. Repeat every three to five years

If you will accept that as a short hand description of what we do today, how could anyone find fault with something so apparently reasonable? Unfortunately, it is riddled with problems.

The 80:20 rule

Today's best practice model devotes most of its time and effort to appraising risk and return against benchmark. Only every three to five years do we manage the risks from the benchmark to the investment objectives. Yet surely the lesson of the last fifteen years is that the risks from the actual portfolio relative to the strategic benchmark are small, sometimes trivially small, whereas the risks from the strategic benchmark to the investment objective are large, sometimes very large.

> "We need to be much more focused on the benchmark that really matters, and that for most charities is inflation and cash flow"

In short, we have the 80:20 rule completely back-to-front. By spending most of our time worrying about market benchmark relative returns, we are missing the point that you cannot pay grants out of relative returns; we need to be much more focused on the benchmark that really matters, and that for most charities is inflation and cash flow.

A better best practice model

So what am I advocating?

I am not advocating abolishing all benchmarks; certainly not. I am advocating replacing market based benchmarks with real world benchmarks directly linked to an investment objective. For an endowment it might simply be to grow the assets in excess of inflation after all spending, including fees and charges.

To be clear, this does not mean eliminating market benchmarks entirely; it just means relegating them to a secondary, much more minor role where they belong. So after you have looked to see if you have met your investment objective, it is entirely reasonable to then go on and ask the question "did I make the most of the opportunities the market presented?" Was this an environment when, say, equities were performing well and how did my holdings do against the opportunity set out there? For that you will want to keep an eye on market benchmarks, but this is absolutely secondary to understanding first how you are doing in the real world.

There is another very important benefit that comes from adopting a real world benchmark in place of the strategic benchmark. It frees up asset allocation, allowing it to be more dynamic and to really work for the fund.

Predictions!

What I conclude from this look back over the last 40 years is that going forward successful asset owners and asset managers are going to listen to Einstein and stop making things too simple. They will acknowledge:

- that tail events are much more likely than a normally distributed world would suggest, and will not be surprised by them.
- that naïve use of volatility as a risk measure serves little purpose, we will use the power that Moore's law has given us to move our models closer to reality
- that there are risks and opportunities that no backward looking statistical measure will ever capture. However we will be foolish in the extreme if we do not try to take into account in our portfolios things that we really should expect to happen. What will be our excuse for having ignored climate change when disruptive technologies make large parts of our portfolios obsolete? To do this we really will have to think and act as long-term investors.
- our behavioural biases. Admitting that such biases exist is the first and most important step to being able to overcome them.

If our regulators allow us, the smart part of the industry will start to act in a counter-cyclical fashion. That after all is how you buy low and sell dear. To do that asset owners and asset managers will need to reorganise themselves and adopt a different governance model. Market related benchmarks will become secondary Real world outcome benchmarks will take their place centre stage. That should be welcomed by asset owners and asset managers alike.

It will be a different, more challenging and more exciting world. Good luck!

Alan Brown has recently retired as a Senior Adviser to Schroders. He joined the Board of Governors of Wellcome Trust in May 2012.

Alan read natural sciences at the University of Cambridge before starting a career in the investment management industry, where he has worked for 40 years. He has held positions as a chief investment officer for the past 25 years.

Alan's other responsibilities include Chairman of the Board of the Carbon Disclosure Project, and Director of the Foundation Board for the Centre for Economic Research and Graduate Education in Prague. He is a non-executive director of Pool Reinsurance Company, a scheme established to provide cover for losses arising from terrorism.

Regulatory update

TOTAL RETURN FOR PERMANENT ENDOWMENTS

Total return is the ability to use capital, as well as income, to meet expenditure requirements and fulfil charitable aims. From the beginning of 2014 permanently endowed charities have been able to adopt a total return approach without needing to seek approval from the Charity Commission.

Traditionally, a permanent endowment is a gift to a charity that cannot be spent, but must be held to produce an income for the charity into perpetuity. Permanent endowments aim to balance the needs of the current and future beneficiaries, which is often expressed as maintaining the real value of the endowment whilst generating sustainable income to fund current spending.

The change in guidance now affords permanently endowed charities greater flexibility in achieving this balance. Under a total return approach, the form in which investment return is received (for example, income, dividend or capital growth) does not matter. Instead, investments are managed to make the most of the total investment return that they generate. This enables charities to focus on investments that are expected to give the best performance in terms of their overall return, rather than on investments which will give the 'right' balance between capital growth and income. The trustees can allocate whatever portion of the total return they consider appropriate as income, which is then spent furthering the aims of the charity. The balance remaining is carried forward as 'unapplied total return'.

The importance of maintaining the original value of the endowment is still paramount, although technically on a nominal basis rather than adjusted for inflation. A key challenge to any charities that wish to adopt this approach is the identification of this original value. This 'core capital' is untouchable, and everything in excess of this value considered as 'unapplied total return' and theoretically available for expenditure. Thankfully the charity does not necessarily need to go back to the original gift value, but can base their 'core capital' on a valuation at a reasonable point in the history of the endowment.

Crucially, when choosing this value, the charity must ensure that there is an adequate safety buffer to ensure that spending can continue in times of market stress, when the value of the endowment may fall. If this value falls below the core capital there can be no spending at all, not even income. That is a pretty big risk for permanent endowments, and one that needs to be considered carefully. The 'right' level of the buffer might take into account your asset allocation and the projected volatility of your investments and might look back in history to see 'worst case' market falls. For the average charity portfolio, this might mean that roughly half of the permanent endowment should be made up of unapplied total return at the outset.

Whilst the changes do allow more freedom, it places further burden on the trustees who must decide the proportion of capital to be drawn down to complement income for spending when balancing the needs of the current and future beneficiaries. It is also a requirement for trustees to identify the original value of the endowment, or indeed choose a historical level at which they feel most comfortable, which may be difficult to evaluate.

> "Total return is the ability to use capital, as well as income, to meet expenditure requirements and fulfil charitable aims"

The total return approach also allows a broader asset mix, as you no longer have to choose assets with a bias towards higher income yield. However, the charity must still be able to fund commitments without needing to sell volatile or illiquid assets. In this respect cash flow remains an important consideration. In addition the total return approach may not be appropriate for all of the permanent endowment, for example investment in direct property does not easily allow capital expenditure.

The change in guidance is welcomed for the flexibility and new power in decision making it allows permanently endowed charities, but it should be carefully weighed against the risks for the individual charity when judging if appropriate.

Cazenove Charities, April 2014

A NEW SOCIAL INVESTMENT POWER FOR CHARITY TRUSTEES?

Hannah Kubie
Senior Associate, Charities & Social Enterprise, Stone King LLP

As part of its review into areas of charity law, the Law Commission has recommended the introduction of a new power for charity trustees to make social investments. The Law Commission is the independent body established by Parliament to review and recommend legal reform in England & Wales. In its Recommendations on Social Investment by Charities (24 September), it recommends the new power to clarify a number of perceived uncertainties.

'Social investment' by charity trustees means using funds to seek both (i) to further one or more of the charity's objects, and (ii) a financial return, which might include income, capital growth, full or partial repayment or just avoiding incurring a future financial liability.

Outside the sector, this might seem a fairly obvious and uncomplicated concept for a charity. However, whilst it is generally accepted that charities may make (most) social investments, and many do, the current law around social investment could be improved.

Charity Commission Guidance CC14 (Charities and investment matters: a guide for trustees), although helpful in filling the gaps between the case law that currently exists, has no statutory footing. Available case law is inadequate and unhelpful, having derived largely from the law concerning investment duties of trustees of private trusts and pension funds. The law concentrates on making financial investments to maximise returns on the one hand (where investment duties apply) and advancing objects through grants, on the other hand; recent cases emphasise risks involved whilst providing little or no confidence.

Different practices have developed in the sector and even larger charities, which should have the resources to make social investments feel inhibited from doing so, particularly where there are innovative structures.

The proposed power will apply unless it is excluded or modified by the charity's governing documents. It would be underpinned by a number of statutory duties, applying in relation to all social investments (whether or not they could clearly have been made under the current law). For charitable trusts, the new duties would replace the Trustee Act 2000 investment duties. The duties on trustees would be:

– being satisfied that a social investment is in the charity's best interests, having regard to the expected mission benefit and financial return.

– to periodically review social investments and consider varying them.

– to consider taking advice when making or reviewing an investment.

The Law Commission also considered social investments using non-functional permanent endowment. Non-functional permanent endowment is investment permanent endowment (funds where only income may be spent but not capital), as opposed to functional permanent endowment, such as a building that must be preserved.

It is generally considered that the law permits a charity with non-functional permanent endowment to make social investments with it, provided the trustees expect the capital value to be preserved. The Law Commission therefore proposes that the new power should apply to all trustees, including those of permanently endowed charities. This would not, however, allow trustees to contravene the spending restrictions; trustees would need to use existing statutory mechanisms to release permanent endowment. However, as some consultees considered the existing mechanisms prohibitive, the Law Commission has said it will also seek to include reviewing that within the terms of its wider charity law review.

The Charity Commission would need to revise CC14 to reflect the new power and the Law Commission recommends it advises trustees to consider a number of additional matters when making social investments, including the duration of the investment, risk, performance measurement, the relationship with the charity's investment portfolio/grant-making and tax. Importantly, the Law

Commission has also recommended that the new CC14 contains new guidance on private benefit, acknowledging that social investments could be made by purchasing shares in private companies.

The Law Commission acknowledged concern amongst trustees that legitimate social investment may not be recognised as such by HMRC therefore resulting in a tax liability. It is recommending that HM Treasury reviews and seeks to amend the legislation concerning approved charitable investments and loans, to reflect the new power, as well as introducing a prior clearance procedure.

It is widely expected that the proposals, which will now be considered by Government, will be implemented.

Hannah Kubie acts for charities, community interest companies and other social enterprises, helping them with registrations, constitutional and governance issues and mergers and transfers. Prior to joining Stone King, Hannah trained and qualified at a magic circle firm, before moving to a public sector firm. Her decision to specialise in the charity sector was in part influenced by her secondment at an international children's charity.

A version of this article first appeared in the Technical Briefing section in Charity Finance in November 2014.

A Wellcome perspective

Danny Truell, Chief Investment Officer of Wellcome Trust, spoke at the inaugural Cazenove Charities lecture at the Tate Modern, London on Thursday 5th June 2014.

Report by Andrew Sheaf, Portfolio Director, Cazenove Charities

Danny shared his thoughts on how the Trust has performed since he joined, some possible threats and concluded with general pointers for charities looking to manage a successful investment portfolio.

"Over the years spent at Wellcome Trust, I have become increasingly convinced that the key issue for charities is not actually total return, but that of charity cash flow instead".

As at June 2014, the Wellcome endowment value stood at some £17 billion, "since joining the Trust in 2005, this endowment has roughly doubled and every day that I have spent working there has seen the value increase by £5 million".

The net outcome now is that the Trust will, in 2015, allocate £800 million to medical research, a sum which will be greater than UK Government provision through the Medical Research Council.

Avoiding disaster

Danny made it very clear that he does not "wish to have, as an epitaph, the man who blew up the investment portfolio of the Wellcome Trust".

On the other hand, the Trust has no divine right to expect any future donations to the endowment. It is important to appreciate that, in effect, the Trust has only ever received one donation, of £1.6 million in 1936. The current endowment value equates to growth of this original donation at a rate of 11% per annum over 75 years, or an appreciation of approximately ten thousand times.

Over the next 5 years, Wellcome will be paying out some £4.5 billion towards medical research, emphasising the importance of effective management of cash flow to ensure that the grants are paid.

What are the biggest threats to the Trust? 3 specific risks:

- **Inflation** - actually the biggest threat, for the Trust has seen a number of periods over its life where inflation has run out of control.
- **Concentration** - too much investment concentration can lead to severe losses during downturns. This has been evident over the latest financial cycle.
- **Liquidity** - risks appear from needing to sell assets (when forced to) at a bad time or when you simply cannot find a buyer.

The importance of luck

The Wellcome Trust has been lucky a number of times since its inception:

1939-45: the decision was taken to move factories out of London, (Dartford), successfully avoiding the immediate consequence of the Blitz. On the other hand, the charity did stockpile penicillin and by 1947 was nearly insolvent as demand for the drug diminished after the war.

1970s: effectively a purple patch for the company, thanks to the activities of two great Americans, Gertrude Elion and George Hitchins. So while the 1970s were actually a very bad period for other endowments, Wellcome's sales rose tenfold.

2000-03: much of the endowment was invested in equities, exposed to the market which was about to sell off dramatically. All of a sudden, Glaxo appeared with a bid for Wellcome and the Trust swiftly acquired 100 million Glaxo shares at an attractive price, bucking the downward trend in markets.

2008-09: the endowment portfolio, by the time of the credit crunch, had become considerably more diversified,

"I have become increasingly convinced that the key issue for charities is not actually total return, but that of charity cash flow instead"

with significant investments outside the UK including dollar cash and hedge fund allocations. However, the Trust had hedged much of the exposure back to £ and with sterling falling, the cash flow implications were significant. By great fortune, $/£ rates then went the Trust's way after all.

To avoid pitfalls and manage risks the key has been cash flow management along with a healthy dose of luck.

Achieving victory instead

Proper diversification started in 1985 and continued successfully through to 1995, moving the investment portfolio much more towards assets generating real returns.

However, through many of these years, the Trust's investment policy was at odds with the Charity Commission's recommendations. In the Courts, Lord Justice Hoffman ruled in favour of Wellcome allowing private equity and venture capital investments, opening up the opportunity to capture the illiquidity premium on offer in such funds. West Coast USA Venture Capital now constitutes a significant part of the portfolio.

In 2006-09, the Investment Committee took great advantage of market timing opportunities and commensurate with this, a policy of using the Trust's balance sheet responsibly was also initiated. The issuance of long term, highly rated bonds (e.g. for 45 years at 4%) has been successful, the mechanism also now been adopted by University of Manchester and Oxbridge institutions as well.

Lessons for charity investors

- Watch out for over-diversification - while the concept of diversification is important, the mantra can also be overdone. The possession of literally hundreds of indirect holdings is simply no good, and likely to give the return of the markets only. Wellcome has 85% of the current portfolio of £17 billion in holding unit sizes of US$100 million at least. In addition, external managers are strongly encouraged by the investment team to have portfolios of 30 or 40 stocks maximum.
- It is important to ensure the interests of corporate managements are correctly aligned with their investors.
- Adopt a 10 year horizon for the successful evaluation of your investment choices, no less, and always retain a degree of flexibility in this stance to reflect market conditions.
- Think hard about potential investment opportunities that you can access which may not be available to other market participants. Thinking in countercyclical terms can be highly profitable given sufficient investment horizon. You should to be able to stick with your positions for the longer term, if necessary to achieve a better return.
- If you can, thrive on the positive achievements of your predecessors and take opportunities to build upon them.
- Get the culture and style of your charity right for operating purposes and for you, too.

The Wellcome Trust can indeed do things that other smaller charities cannot do. However, the philosophy and approach has lessons for charities of all sizes.

Danny Truell joined Wellcome Trust in 2005, having previously been a Managing Director of Goldman Sachs and Co. in its investment management division. Prior to joining Goldman Sachs in 1996, Danny's career was focused on Asian financial markets.

Musings from the desk

Kate Rogers
Head of Policy, Cazenove Charities

A selection of short articles published in the sector press over 2014

IN DEFENCE OF THE ACTIVE MANAGER

The editor has challenged me to tackle the 'monkeys beat fund managers' headlines so often banded around the press. Why should charities pay investment managers healthy fees, when low fee index funds, that replicate the market performance are increasingly available? The implicit accusation is that the average returns from investment manager efforts, may not justify the higher cost.

I should first say that I don't disagree that index approaches are very useful to have in the armoury, as a relatively cheap way of getting exposure to an asset. But I do challenge the suggestion that charities should throw in the active management towel and invest all of their assets in cheaper, index funds. And this is why…

Asset allocation cannot be passive

First and foremost it is important to remember that one of the biggest decisions a charity can make is how they allocate their assets. Even the best bond fund manager might underperform the worst equity manager in a strongly rising equity market environment. Many academic studies show that it is the asset allocation decision that is the most crucial determinant of long term returns.
It is also inescapably 'active' - however, a charity chooses to manage their portfolio, they cannot avoid making a decision about which broad categories of assets to use; whether equities, bonds, property or alternative assets. Once that course has been charted, the charity then needs to decide whether to use active or passive management to gain access to those assets.

Passive investing brings risks…

Investing using passive indices can certainly have benefits, including diversification, transparency and low costs, but these strategies also carry their own risks. As equity indexes are weighted by company size, the bigger companies dominate. It may seem intuitive to weight equities in this way, but there are a number of problems. One is that investors are buying into yesterdays' winners, those companies that have performed well and are now more prone to underperformance. Forcing investors to buy expensive equities that have gone up a lot and to sell cheap ones. Not a recipe for strong performance. Active managers are able to capitalise on these biases and select from the areas of the market that may be expected to outperform over the long term.

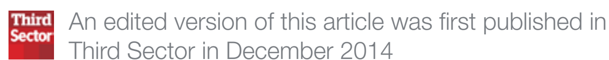
> "Charities choosing a UK equity index approach had over 8% of their UK equity exposure in BP and Shell"

At the end of 2013 the top 10 companies made up 36% of the total UK market, meaning that charities choosing a UK equity index approach had over 8% of their UK equity exposure in BP and Shell and almost 6% in each of HSBC and Vodafone - a significant concentration risk. Index investors are prone to a lack of breadth in their investment strategy, unnecessarily restricting investment choice and biasing away from mid and small companies, which have been shown to outperform larger companies over the long term.

Active managers are not all created equal

'Average' active manager performance tends to oscillate with market cycles. The recent past has been a strong period for active managers, with the average UK equity manager 10% ahead of the index in the 2008 to 2013 recovery, but that is not always the case. However, there is one type of manager that has been found to be consistently more likely to outperform net of fees and transaction costs. These are the 'stock pickers' - those managers whose portfolios diverge markedly from the index and who do it well.

So although index funds hold many attractions, I still believe that there are managers who can capitalise on index biases, and clever analysis, to put together portfolios of companies likely to outperform. It seems to me that in the current market environment, which is likely to be characterised by divergence in fortunes, I'd rather have a professional than a computer (or a 'monkey') looking after my charity's assets.



An edited version of this article was first published in Third Sector in December 2014

WHERE HAS ALL OF THE MONEY GONE?

The crisis is over, our banks are stronger and our equity market is higher. The UK is celebrating being one of the fastest growing developed economies in the world. But are we better off? The headline GDP figures hide an increasing disparity between the rich and the poor both at home and overseas.

It is striking that the richest 1% of the UK population are now wealthier than the poorest 50% put together. This gap has been getting bigger and was exacerbated by the 'extraordinary' response to the crisis.

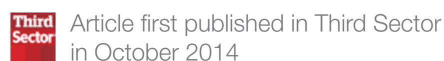
£375,000,000,000 has been injected into the UK economy through 'quantitative easing'. Where has it all gone? Tracing the money flow shows us how these billions moved from the Bank of England coffers to banks, pension funds and other institutional investors, buying up vast swathes of the government bond market, pushing prices up and yields down. It is this yield compression that was supposed to stimulate the economy, making it less appealing to save and more appealing to borrow and spend, a tricky thing to understand for an economy seeking to undo many decades of over reliance on credit cards and bank loans. What quantitative easing certainly did was stimulate asset markets. The billions that went from the bank to investors to buy their government bonds was soon recycled into more attractively valued equities and property, boosting prices.

> "£375,000,000,000 has been injected into the UK economy through 'quantitative easing'. Where has it all gone?"

All good and well for the 'haves' with their homes and equity portfolios. But spare a thought for the 'have nots'. The less privileged in our society, who have not benefited from this asset price inflation and have been hit by a government intent on reducing spending. It is, perhaps, no coincidence that the Trussell Trust reported a 163% rise in people being helped by their food banks in the last twelve months.

What happens now? An economic recovery that has seen increases in asset values coupled with rising inequality is not, in my mind, a particularly stable footing for the next 'leg' in the economic recovery or, more importantly, a healthy, happy functioning society. In the next recovery stage we would expect to see a normalisation in interest rates. According to Shelter, families in the UK spend more than 40% of their household income on rent, mortgage payments and other living costs. Any increase in these costs could severely squeeze households placing yet more in the charitable hands of the Trussell Trust food banks.

Our policy makers will be treading a fine line between increasing interest rates quickly enough to manage the inflation in asset prices (particularly the housing market) and slowly enough to keep the indebted UK consumer spending and without derailing the delicate recovery. What it seems all are agreed on is that the outlook for government spending remains bleak particularly after the next election. Those dependent on the state are unlikely to find their financial lives any easier, despite the billions invested, the market recovery and the much celebrated GDP figures.



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IS VOLATILITY RISK?

Eeek - risk. We're all charities, we hate risk (don't we?). Particularly financial risk. An understandable starting point perhaps, especially for hard earned fundraising proceeds in times of need. But are we missing the point and, more importantly, an opportunity?

It is probably best to start at the beginning and ask the simple (sounding) question. 'What is risk for charities that invest?'

Elementary, my dear reader (I might say)... of course risk is volatility... or the amount that the value of your investment asset yo-yos around.

Or is it? Worry not, I do not intend to bore you with statistical definitions or a greek alphabet soup of terms. Instead I want to think about whether this sort of risk is the most important or most concerning for your charity investment pot.

The bulk of charities that invest do so for the long term. That isn't just a few years, or even decades, but can be many hundreds of years. In this scenario why does the value of your assets matter on a daily, monthly, quarterly even annual basis? If your house was valued every day would you worry more or less about living there for twenty years? Capital value only really matters when you want to sell the investment.

So if volatility isn't the key risk, what might be? What is the investment there for? For long term grant making foundations, it is probably there to generate an income (whether funded wholly from income or from total return) so that you can support your beneficiaries. So cash flow is a key risk from year to year. Over a longer time horizon, you will want this income generation, or the amount that you are able to donate, to increase at least in line with inflation. Here lies your second large risk, inflation over the long term. Thirdly, you will need to have strong governance in place, to avoid the risk of changing course or strategy at a bad time, and undoing all of the long term investment thought.

Quantifying risk as volatility is appealing, and does have its benefits in both the construction of a sensibly diversified portfolio and the appraisal of your investment manager's returns (making sure they are not taking too much risk for the level of return). It is natural to seek the comfort of numbers, but I would argue that this is hugely misleading. Cash is not volatile, therefore is low risk… stock markets are volatile therefore are high risk. But the latter has a much better chance of keeping up with or outpacing inflation over the long term time horizon that most of us are worried about.

> "If your house was valued every day would you worry more or less about living there for twenty years?"

The investment managers are as culpable in all of this as the charity investment committees. By providing quarterly performance data, rather than focusing on the long term, we emphasise short term volatility and amplify the anxiety that many charity trustees feel about preserving capital value. By forever benchmarking against market indices (or strategies) we encourage a lack of focus on the long term investment objectives, and the key risks that each charity really faces. Do we actually care if we do better than the market, if the market is falling or not keeping pace with inflation? If all of our analytical time and energy is consumed by benchmarking and volatility I suspect that we risk missing the wood for the trees.

Risk may be a 'boring' topic, but the appraisal of what really matters to your charity is so important for your investment portfolio and long term strategy. If we focus on what each charity wants its investments to achieve rather than market related statistics or frequent reviews, we will have a much better chance of grasping opportunities and making the most of our charity assets.

An edited version of this article was first published in Third Sector in August 2014

TO SPEND OR TO SAVE?

It might be my age, but time seems to be passing at pace. It really doesn't seem like over 7 years ago that the credit crisis began… but it was. Perhaps it provoked a strong enough negative emotion to form an indelible memory, or perhaps it is the ramifications that we are still living through acting as reminders; increased regulation in the financial sector; less loans from the banks; and the slow, drawn out economic recovery. UK GDP has only just surpassed the levels seen prior to the crash. But that hasn't stopped the markets. The equity market low point came in March 2009 when the FTSE 100 reached 3,500. Today, the same index stands at over 6,700. That puts this 'bull market' at a ripe age of almost 6 years, which is longer than the average market upturn lasts. Despite the slow and bumpy economic recovery, investors, at least, are feeling optimistic. Charities investing their assets have seen values improve substantially, a welcome relief from the choppy markets experienced in the first decade of the millennium. After much belt tightening, and concern over spending patterns, should charities be taking advantage of stronger investments to take some profits and increase spending? It comes back to the familiar question: to spend or to save?

This difficult question is one tackled by trustee boards up and down the country. Interestingly, our research suggests that their responses vary significantly. There are charities that emphasise the importance of longevity. These boards are focused on maintaining the real value of their assets over the long term so that they can continue to deliver their charitable mission indefinitely. These are the 'savers', who may be permanently endowed or have a strategic wish for sustainability.

At the other end of the spectrum are those boards focused on meeting a perceived increase in need, as budgets and donations from other funders are cut. These charities have been increasing spending and reducing their asset base at varying rates, perhaps with the intention of overall spend out, or to fundraise and recoup the spent capital in future years.

Is your charity a spender or a saver? For the savers, or those charities seeking perpetuity, it follows that the assets must grow in line with inflation to maintain purchasing power. Current charitable expenditure should be funded from any excess returns, over and above inflation. But what is this magic number? What amount can a charity afford to spend without risking its long term sustainability? The answer will depend, of course, on asset allocation (where the money is invested) and the level of returns in the future. Time to polish the crystal ball I fear. Long term return analysis suggests that expenditure levels of 4% should be sustainable for charities with a long term asset allocation strategy. These strategies are necessarily biased towards real assets, so equity and property markets, which historically have generated the best returns against inflation.

So whether to spend or to save? Research does support the view that taking more out of investments in good times is a good idea, but only if the reverse is also true - you can afford to take less out in more difficult market environments. It is the latter that most charities struggle with. Times of market stress are often those times when charitable need is heightened. And stable spending is, understandably, highly prized by charities. In the research undertaken for ACF's 2013 report, For Good and Not for Keeps, data showed that over the economic downturn 80% of the 226 charities surveyed had at least maintained their spend. So if you can't decrease your spending in bad times, should you increase it in good times? The answer depends on the overall aims of your investment strategy. Are you, like permanent endowments, striving for perpetuity or can you take more risk with your longevity? Higher spending rates will decrease the likely 'life' of your investment portfolio. An alternative approach might be to bank some of the gains now, in a spending reserve, to be dipped into in tougher times. If you are anticipating more choppy water ahead, this is probably something worth considering.

Article adapted from one first published in Charity Finance Group's membership magazine, Finance Focus, in August 2014

Kate Rogers has twelve years' investment experience, specialising in investment on behalf of charities, endowments and foundations and joined Schroders Charities in 2005 after four years with Kleinwort Benson Private Bank Charity team.

Kate is chair of the Charity Investors' Group, which is a membership organisation providing a forum for investment debate. In this role she has collaborated with CFG to launch a guide to written investment policies. She also co-authored 'For Good and Not For Keeps' published by the Association of Charitable Foundations in 2013.

Kate is Head of Policy at Cazenove Charities. She is a CFA charterholder and has a BSc (Hons) in natural sciences from the University of Durham, is Chair of her local community foundation, and governor of her local primary school.

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Important information

Past performance is not a guide to future performance. You should remember that investors may not get back the amount originally invested as the value of investments, and the income from them can go down as well as up and is not guaranteed.

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