

CHARITIES MANAGEMENT

The magazine for charity managers

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THE INVESTMENT CHALLENGE



The cornerstone of the successful management of assets is the development of an investment policy tailored to meet the individual needs of the charity.

At Thomas Miller Investment, we manage portfolios across a wide range of asset classes and provide boards and trustees with professional and experienced fund management capabilities. We understand that no two charities are alike. For this reason, we always work closely with our clients to achieve a common understanding of their aims, aspirations and objectives before formulating an investment policy and appropriate performance benchmark.

We believe this work is essential to helping charities meet their investment challenge.

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The fact that China and the smaller Asian economies are unable to absorb the inflow of capital is a major driver of outside equity markets.

Understanding equity markets

OLIVER BOYLE, a director of **Thomas Miller Investment**, explains why equity prices look so strong and says that charity trustees must now reappraise their investment policy.

The sharp fall in equity prices in 2000 and the ensuing bear market caused real financial hardship for charities. Many charities had not married their investment policy to their needs. They believed that a 100% investment in equities was the norm.

A move towards focusing on risk management, as opposed to investment return, slowly appeared – things like benchmarks entered their world.

This episode triggered the regulators and the Charity Commission to issue guidelines to trustees about the need for prudence and to buy in financial expertise.

The rally in equities last year has resulted in a collective sigh of relief from charity trustees. The world has gone back to normal.

One year of exceptional equity returns has wiped the slate of the last five years clean. Complacency is back.

“At present the excess liquidity is most obvious in global bond prices because this is the major asset holding of governments.”

This is just the time, however, when trustees should sharpen their pencils and take a long hard look at their investment policy and assess it in accordance with their financial needs.

If the current alignment of economies and financial markets is said to represent a “conundrum” for the world’s leading central bankers then trustees should at the very least be taking steps to review their investment policies sooner rather than later.

growth

The global economy over the past two years has registered its strongest growth for decades and it looks like it will continue this strength into 2006.

Yet long term interest rates in the major bond markets are low in both nominal and real terms.

The US Federal Reserve has been raising interest rates for two years but long term interest rates have risen only modestly.

The increase in US short term interest rates should have increased risk in the



The US is one of the main recipients of Asia's savings which are unable to find a home in their domestic markets.

form of higher volatility, but volatility is historically low and stable.

The yield spread between corporate and government fixed income securities of similar maturity should also have widened in response to the rise in interest rates, but this has not been the case in the US or Europe.

The most likely explanation for these anomalies is a glut of global savings.

This might seem strange when the media is filled with stories of rising government deficits, consumer debt and pension fund deficits of the industrialised economies.

It is the Asian economies, however, which are saving as reflected in the sharp rise in their trade surpluses.

bulk

The bulk of these trade surpluses is with the United States and is in US dollars.

The financial systems of China and the smaller Asian economies are unable to absorb the inflow of capital.

Therefore these countries invest their savings overseas where the US is by far the largest recipient.

These savings are typically invested in low risk US government securities and US deposits.

Now that US short term rates are yielding over 4.25%, compared with

2.25% in Europe and 0% in Japan, more capital is attracted into the United States.

obvious

At present the excess liquidity is most obvious in global bond prices because this is the major asset holding of governments.

“The bigger risk in 2006 to global liquidity is turbulence in the financial markets caused by an unexpected event in the credit markets.”

Other asset prices, such as property and equity, benefit as investors with broader portfolios shift out of expensive bonds into assets that are perceived to be less expensive.

history

History shows that the end of liquidity fuelled asset price inflation is not caused either by a tightening of monetary policy

or by a substantial loss in the financial system such as occurred in the Long Term Capital Management episode in the US.

Identifying this trigger is an important determinant of investment strategy in 2006.

US interest rates are unlikely to rise sufficiently in 2006 to cut off the flow of liquidity.

The Federal Reserve would only take such actions if the pace of domestic inflation accelerated sharply.

stable

The availability of low cost products from overseas coupled with healthy productivity gains in the US means that despite the tripling of energy prices last year the underlying rate of inflation is broadly stable.

The bigger risk in 2006 to global liquidity is turbulence in the financial markets caused by an unexpected event in the credit markets.

The reason is that the combination of low borrowing costs and low volatility induces investors to take on additional and excessive risk, knowingly or not, in order to try and boost investment returns in a low return environment.

There is some concern that the liquidity from global markets could be removed by holders of US dollars, such as the

governments of China and Japan, selling their holdings of US dollars.

However, this is a risk of more theoretical than practical interest.

The likelihood of these authorities selling US dollars and buying their own assets is very slight as it would cause their own currencies to appreciate enormously and push their economies into recession.

limited

Likewise, the opportunity to diversify their US dollar assets into other currencies is very limited.

The Japanese yen is not attractive as it offers zero return and the fixed income market of the eurozone is too small and fragmented to offer more than marginal opportunities.

Against the backdrop of inflated bond prices but healthy global economic growth in North America, Asia and the Middle East, equities are likely to provide superior returns to fixed income securities in 2006, although the volatility of the return on equities will be greater than on fixed income.

Equity valuations of the major markets are not far from their historic values but certainly offer attractive yields relative to bonds.

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Despite the media hype of diminishing returns in hedge funds and private equity, both asset classes continue to offer attractive investment opportunities for charity investors.

Prudent management of hedge funds has yielded superior returns to cash with less volatility than either equity or fixed income securities.

Weighting a portfolio of hedge funds away from credit sensitive strategies is likely to help avoid some of the volatility in the asset class, and well researched and focused private equity proffers attractive returns for those investors which do not require regular income.

However, this might not be the case for the majority of charity investors.

important

An understanding of the cause of the surge in liquidity and the likely trigger for its contraction is important for charity investors.

But as history proves, it is likely that most investors will only understand the cause after the event and that successful fund performance will hinge principally on their risk management philosophy and the robustness of their risk management controls.