Investment Strategy – Recommendation

Purpose

The purpose of this paper is threefold:

1) To provide the Committee with an update on the work that has been done on developing the Union's investment strategy since the Board meeting on 29 June 2017 at which a discussion paper (see Appendix I) was advanced and responded to.
2) To provide the Committee with an outline of three approaches to finalising the investment strategy, and the main considerations under each approach.
3) To recommend to the Committee that it approve the third approach outlined.

Update

At the Board meeting on 29 June 2017 it had been recommended that the Board approve a target investment return of inflation +3% and that further deliberation would be required to determine the Union's risk appetite in terms of identifying appropriate asset classes to invest in and how the Union's ethical investment approach would apply to this. The Board expressed a conservative approach to investment risk and requested that these questions be dealt with at Committee level, and that the advice of College and external investment experts be sought and taken into consideration, before returning to Board with a set of clear recommendations.

A working group was then formed consisting of the Deputy President (Finance and Services), the Head of Finance and Resources, the Finance Manager, and the Union's elected Ethics and Environment Officer. This group has held a series of meetings with the following investment industry experts:

- Philip Blennerhassett of Fisher Investments
- Rachel Coowar and Nick Beal of David Williams IFA
- Gilbert Rizk of GNA Consulting
- Neil Thomas of Independent Investment Reviews Ltd.

In addition, a number of consultations with Anh Duong, the Head of Treasury Management at the College, have taken place.

All of these experts have confirmed that a target investment return of inflation +3% is both realistic and compatible with a relatively conservative investment risk appetite. They have also confirmed that adding an ethical investment overlay to these objectives is possible, but adds an extra level of complexity to the investment strategy process. It is clear from the discussions that this is particularly so given the Union's specific ethical investment requirements in terms of excluding fossil fuels, which up to now, have been a relatively unusual feature of ethical investment portfolios compared with alcohol, tobacco, fast food, gambling, pornography and weapons.

Alternative Approaches to an Ethical Investment Strategy

1. Leverage College

   The College has an established endowment fund with its own governance structure, with the aim of providing College with a material and growing source of funds for its activities. It manages three portfolios, including a unit trust fund called the Unitised Scheme. This fund has an investment target of RPI +4% over a rolling 5 year period with volatility (risk) of less than 1 times that of global equity markets. Under this approach the Union would either invest directly in the Unitised Scheme or work with the Endowment team to create its own mirror fund.

   Advantages:
   1) Ready-made structure and strategy.
   2) Better investment return target.
   3) Higher risk, but requires no higher a risk appetite than College's.

   Disadvantages:
   1) Not tailored to Union's specific risk appetite.
   2) Does not satisfy the Union's ethical investment requirements.
   3) May involve some loss of control of Union funds unless an adequate level or form of Union representation is incorporated into the Endowment governance structure.

2. Select an Investment Manager/Product

   Both Fisher Investments and David Williams IFA can construct a portfolio to meet the Union's specific investment return, risk, and ethical requirements. The Union could extend the pool of investment managers/products to choose from by identifying and arranging to meet others, such as M&G Investments, for instance (with whom the Union has a small existing Charifund holding).

   Advantages:
   1) Investment solution tailored to the Union's specific requirements, including ethical investment policy.
   2) Access to external expertise.
   3) Direct control over selection of asset classes

Disadvantages:

1) Time-consuming process of manager/product identification, meeting, and evaluation.
2) Lack of industry knowledge and investment expertise to find and evaluate most appropriate managers/products.
3) Without the right expertise and advice, applying an ethical overlay excluding fossil fuels to the wrong portfolio could involve adding extra risk.

3. Engage an Investment Consultant

Both Gilbert Rizk and Neil Thomas are investment consultants who can construct and carry out an investment manager selection process to scan the investment market place and screen for the best and most appropriate investment managers and products that meet the Union's specific investment return, risk and ethical requirements.

Advantages:

1) Access to high quality investment industry knowledge, expertise, and contacts.
2) Time-saving and high-quality investment manager/product selection process.
3) Potential on-going cost savings by leveraging consultant to negotiate competitive and transparent investment manager and custodian fees.
4) Better match between Union's investment aims and realised investment strategy more likely.

Disadvantages:

1) Additional one-time fee – indicative £8,000 to £10,000.

Recommendation

Unlike options (2) and (3), option (1) does not directly fit the Union's investment requirements and on that basis it can be ruled out. While both options (2) and (3) may lead to equally satisfactory investment strategy outcomes, there is a greater future down-side risk associated with option (2) due to the particular nature of the Union's ethical investment strategy (fossil fuels). The only way to reduce this risk is to move towards option (3) bringing independent and broad market knowledge and expertise to bear on tailoring the Union's investment strategy.

While we do not know how much additional volatility an exclusionary fossil fuels overlay would add to a portfolio, if we were to assume it might introduce a tracking error of 0.75%, for example, then given a conservatively invested £1.5m portfolio with a 25% equities asset class allocation, then the additional downside risk would be approximately £2,800 per year. If this tracking error were to hold over 5 years, then the cumulative risk would be £14,000.

These are just illustrative figures, but they put the additional one-off cost of option (3) in better context. Provided option (3) eliminates any negative tracking error, as it is expected to do, then it justifies itself in financial terms. Adding to this the other additional advantages, such as the potential to negotiate and reduce investment manager fees, which indicatively will be in the region of an initial £15,000 (1%) plus ongoing £24,000 (1.6%) per annum, then the engagement of an investment consultant is clearly not alone desirable, but advisable and financially justified.

Next Steps

1. Comparative evaluation of services and expertise offered by GNA Consulting and IIR Ltd., and costs.
2. Recommendation of appointment to the Board (1 February 2018).
3. Agreement of work programme and timetable with appointed investment consultant – estimated that the process (see appendix II) from appointment of investment consultant to appointment of investment manager will take 6-8 weeks (completion 16 – 30 March).
4. Investment Strategy implementation will then take place according to a timetable to be advised by and agreed with the appointed investment manager.

Appendix I – Investment Strategy Discussion Paper

Board of Trustees, 29 June 2017

Purpose

The purpose of this paper is to inform a discussion of the proposed new investment strategy for the Union. The primary outcomes required from this discussion are as follows:

1) Confirmation of the Union's target investment return
2) Decision on the Union's risk appetite
3) Agreement on the Union's investment approach
4) Clarification of the next steps and broad timelines

Once these outcomes have been arrived at, the Union will then be in a position to start approaching a range of investment funds, managers, and (if appropriate) consultants. Realistic timelines for this process need to be agreed and put in place.

Current Position

The Union is projected to end the year with a cash balance of £1.9m, which represents its lowest point on the annual cash cycle. In addition, the Union has a long standing investment of £0.1m in the M&G Charifund pooled investment portfolio. The fund has performed steadily against its relevant benchmarks over the last five years, and has yielded a net dividend of £5,740 for the Union over the current year (over 5%).

As part of the Union's response to *Divest Imperial*, it is proposed to liquidate the Charifund investment, on the basis that the portfolio is not subject to an ethical investment policy. This will add these funds to the Union's total pool of cash available for investment. Accordingly, the total pool available for 2017/18 is estimated at **£1.25m**. This will allow the Union a buffer of £0.75m for any unexpected cash fluctuations throughout the year[1]. In addition, the Union will have surplus cash of between £0.6m and £0.9m during its peak cash period, from October to June.

Ethical Investment Policy

There are a spectrum of approaches to ethical (otherwise known as or "sustainable") investing, ranging from "exclusionary screening" to "impact investing". At the former end, the investor seeks to avoid investing in stocks or sectors that do not align with its stated values. At the latter end, the investor seeks to generate positive and measurable social and/or environmental impact through its investments. In between, are a range of approaches where the investor seeks to maximise long-term investment returns by integrating ethical considerations into its investment strategy.

[1] As an additional "safety net", the Union will be able to call upon the College overdraft facility if required at any point during the year.

The exclusionary screening approach is the most common approach to ethical investing, and is the one which most directly corresponds with the aims of *Divest Imperial*. The main consideration to be highlighted in relation to this approach is that by simply eliminating specific stocks or sectors from a portfolio, a tracking error may be introduced which could possibly have a negative impact on performance. For this reason, the Union may also want to consider specialist sustainable portfolios, as part of this approach.

A research paper by J.P. Morgan Private Bank shows that sustainable investing can at least match the performance of relevant benchmarks, but highlights the importance of the investor striking the right balance between its ethical objectives and its risk and return expectations. It sets out the following broad approach to moving towards ethical investing:

1) Identify and articulate long and short term financial goals, risk appetite, and liquidity requirements.
2) Articulate relevant non-financial goals, including ethical requirements.
3) Understand current fund performance and the impact possible sustainable investing approaches might have on this.

The Union’s budget for 2017/18 anticipates £42,100 in interest income. Of this, £1,800 is expected to come from the pooling interest earned on the Union’s operating cash balances (as normal – but reduced, due to lower operating cash balances). The other £40,300 is expected to come from returns on the £1.25m investment pot as well as the surplus cash balances during the year. This implies a ***required net return*** (after fees and inflation) of **3%**. It also assumes that surplus cash can be placed on a short-term basis earning a return of 50bps (0.5%).

The Union must decide how “hard” an approach it wants to take in relation its ethical investment policy. It may pursue an indirect approach whereby certain parameters must be met such as the top 10 holdings must not include certain stocks or sectors or no more than 10% of investment returns should come from certain stocks or sectors. On the other hand, it may pursue a more direct approach, which may require more active management (and therefore more cost).

In either case, the most efficient investment vehicle for the Union’s £1.25m long-term investment funds is likely to be pooled funds, (such as the existing M&G Charifund), some of which offer an ethical overlay. The Union would need to satisfy itself that level of ethical overlay provided is hard enough according to its adopted approach. The advantage of pooled funds is that they are VAT efficient and involve no stamp duty for charities, and are generally relatively lower in terms of costs. A typical pooled fund comprising a 60/40 equity/bond split has on average yielded annual returns of 6 to 8% over the last few years. The outlook for the next few years is for lower returns in developed markets, perhaps down to 4.25% per annum before inflation and fees.

If an appropriate pooled fund cannot be identified, the next option is a tailored fund, which will involve higher costs. Accordingly, the Union would probably have to target a higher investment return in order to achieve its required net return, and this will inevitably involve investments in riskier holdings. It is worth noting, therefore, that the harder the Union's ethical investment approach, the higher its risk appetite will probably needs to be, in order to achieve its required net return.

It may be assumed that the pooled operating and short-term surplus cash will fall outside the scope of the Union's ethical investment policy, because these funds will probably all be held in deposits or cash funds.

Risk Appetite

In deciding its risk appetite the Union must ask itself how much of the £1.25m investment pot it is willing to lose? Higher returns will be offered from emerging markets and alternatives, but both of these are significantly riskier in terms of capital preservation. Generally, as we have experienced with the M&G Charifund holding, investment grade stocks in a diversified portfolio, overall, will yield positive returns over the long term.

Next Steps

Once the matters outlined above have been discussed and agreed, the Union can start to examine and assess the range of investment options available. This can either be done in-house, through a continuation of the process initiated in this paper, or by engaging an investment consultant as a one-off exercise. This service is provided by a range of big names such as Towers Watson, Mercer, and Thomas Murray, whose fees may not be justified in terms of the Union's relatively small investment pot. Alternatively, an independent financial consultant may be able to provide better value for money, and it should be possible to compile a list of names to approach.

Recommendations

1. The Board sets a target net investment return of 3% minimum.
2. The Board to discuss and agree the proportion of the £1.25m investment pot to be placed in investment grade holdings or better, with the remaining proportion being available for riskier investment classes.
3. The Board to confirm whether (A) a hard ethical approach is to be taken across the entire £1.25m investment pot or (B) an ethical overlay (softer) approach can be taken in relation to the investment of the lower risk portion of the portfolio.
4. Indicative proposals from a list of independent consultants be gathered and presented for the Board's consideration by the beginning of August.

Appendix II – Outline Scope of Work for Investment Consultant

Discovery, Review and Assessment

- Review current Investment policy
- Review current Reserves policy
- Assess projected capital inflow, expenditure and income requirements

Strategic Planning

With the information gleaned from the discovery phase, create a strategic plan to enhance the effectiveness of the current policies and strategies.

- Create new investment policy
- Suggest any required amendments to the Reserves policy
- Write new Investment Management section for the risk register
- Compile a strategic document giving options to the Committee to consider with regard to the proposed investment portfolio and short term cash, factoring in projected Income, capital and operational expenses, include the following:
    - Differentiation and allocation between short and medium/long term portfolios
    - Establish mandate parameters for investment guidelines including ethical restrictions
    - Suggest a suitable Benchmark as reference for performance measurement
    - Provide initial discussion on the Investment manager Selection Process

Investment Manager Selection Process

- Write Request for Proposal (RFP) incorporating criteria for managers to be considered for tendering process to manage ICU's Portfolios
- Research Investment managers able to provide an investment solution to meet the Union's criteria
- Distribute Investment guidelines to a list of suitable Investment Managers requesting full investment proposals
- Following discussion with the Committee, invite the agreed short listed Investment Managers (IMs) to present proposals in person
- Attend Investment Managers pitch presentations and advise Board on selection of preferred choice(s) of IMs
- Support in negotiations with preferred IM(s) to achieve final agreement on terms and fees