JPMorgan Fleming
Asset Management

Charity Investment Industry Survey 2003

Foreword

I am delighted to introduce the Charity Investment Industry Survey 2003. This is the third year we have carried out this analysis of charities and their approach towards managing their investment assets.

This is a particularly interesting year in which to assess these findings. In our last survey, carried out at the end of 2002, charities – along with all the investment community – were in the grip of a protracted bear market which was placing formidable pressure on everyone to make prudent investment choices.

With markets have fallen approximately 40% from their peak at the height of the dot.com boom in 1999/2000, many charities and foundations could have been forgiven for keeping their carefully accrued assets far away from the vagaries of the stock market. But a year on, and the sustained market rise we have witnessed since the end of the Iraq war last spring has reminded us once again that equity markets do indeed have a part to play in a charity's endeavour to deliver the best return it can on its assets.

The respondents to this survey were polled in December 2003 and would therefore have experienced around eight months of market rises – but with the memory of the recent bear market fresh in their mind. It has therefore been interesting to see how being caught on the cusp of a contrasting investment environment has informed opinion and actions.

Certainly, the ad verbatim comments we have presented from respondents at the back of the survey reflect a widespread concern of a return to bear markets and massive uncertainty over the correct investment strategy to take in this environment.

The concurrent effect of economic decline on fund raising and stock market decline on asset values produces a nasty double whammy for charities, making the last three years particularly difficult.

For charities who are nervous that the market's recent rebound is only a brief reprieve, I would like to underline JPMorgan Fleming's considered view that the global recovery, and the accompanying rise in stock markets, is sustainable. With inflation at historically low levels, central banks are focused on reflating their economies and although interest rates have risen to regulate consumer activity they are still set to remain historically low.

Overall, authorities across the global are working hard to ensure that the emergent recovery can be sustained. In turn, this is supporting a more stable performance from stock markets.

In investment terms at least, we therefore believe charities are past the worst. While the high-octane returns of the 1990s are not likely to be repeated by mainsteam asset classes, institutions can expect a good real return provided they maintain a properly diversified portfolio and take advantage of the full complement of asset choices open to them. If charities take this approach, we firmly feel they can expect brighter times ahead.

James Saunders-Watson
Head of Charities, JPMorgan Fleming Asset Management

Contents

Charity Investment Industry Survey 2003

The Findings

In their own words

Survey highlights

Key findings from this year's survey:

- **Charity assets have seen a turnaround in performance.** On average charities saw their assets rise +7% this year compared to a decline of –17% in the previous year. (See page 5.)
- **More charities are using pooled funds.** The percentage of charities using pooled funds to invest their assets has risen from less than one in three in 2001 to more than one in two today. (See page 4.)
- **Risk appetite is increasing.** The percentage of survey respondents choosing to reduce their exposure to equities has nearly halved since last year's survey. (See page 7.)
- **Charities are seeking alternative sources of return.** The percentage of charities investing in hedge funds has doubled since our last survey. (See page 10.)
- **Principles more important than performance.** Only 16% of charities with ethical investment restrictions are concerned that it might affect performance. (See page 11.)
- **One in five charities don't hold regular manager reviews.** Around 20% of charities only hold formal reviews of their investment manager when they are dissatisfied with performance. (See page 14.)

Who we surveyed

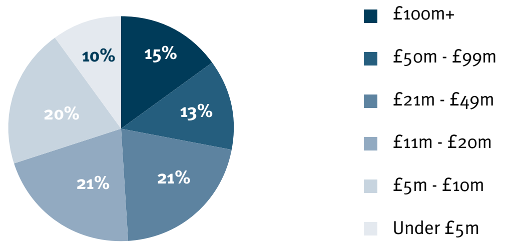
About our respondents

The Charity Investment Industry Survey 2003 is a major initiative to build up a picture of investment trends within the charity sector and to determine how the recent economic climate is affecting the way in which charities are managing their assets. This survey has previously been conducted in 2001 and 2002.

At the end of 2003, we contacted over 1,000 of the largest charities in the UK and successfully interviewed 133 organisations. Collectively, these 133 organisations account for £21.5 billion in charity fund assets.

The volume of investment assets under management varied widely between the charities we surveyed, ranging from less than £5m to over £100m. The chart below breaks down the percentage of respondents by value of assets under management.

Breakdown of respondents by assets under management



The Findings:

How charity assets are managed

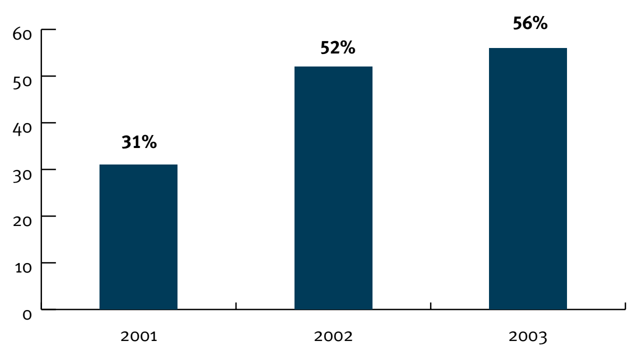
Segregated versus pooled management

Of the 133 charities surveyed, three-quarters manage their funds on a segregated basis, with almost half only using this method to manage their assets:

Method of asset management	2002 %	2003 %
Segregated only	48	44
Pooled only	25	25
Both Pooled & Segregated	27	31

In general, the greater a charity's assets, the more likely it is to use segregated management. However, there has been a growing tendency to use pooled funds within the charities sector. Fifty-six percent of charities surveyed now use some form of pooled vehicle, compared to only 31% in 2001. As we shall also see later in this report, fewer charities are citing size as a reason for not using pooled funds.

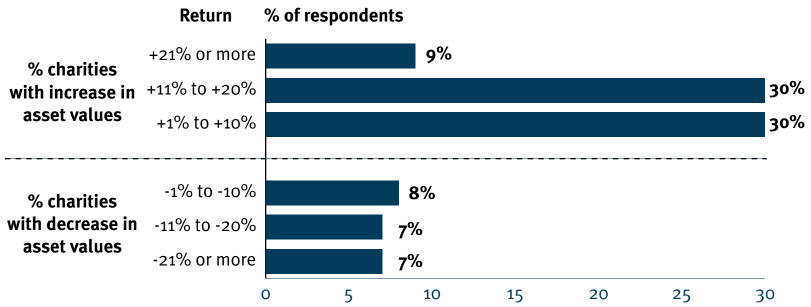
Growth in use of pooled funds among charities



Investment assets - year on year change

We asked charities to give the value of their assets as at September 2003 and also as at September 2002. This allowed us to calculate the average percentage change in the value of assets over the period:

% change in value of charity assets



Of those charities which provided figures for both periods, more than two-thirds reported an increase in the value of their assets between September 2002 and September 2003. The average increase was +7%. This represents a considerable turnaround from the previous 12-month period, during which charities saw their assets decline by an average of -17%.

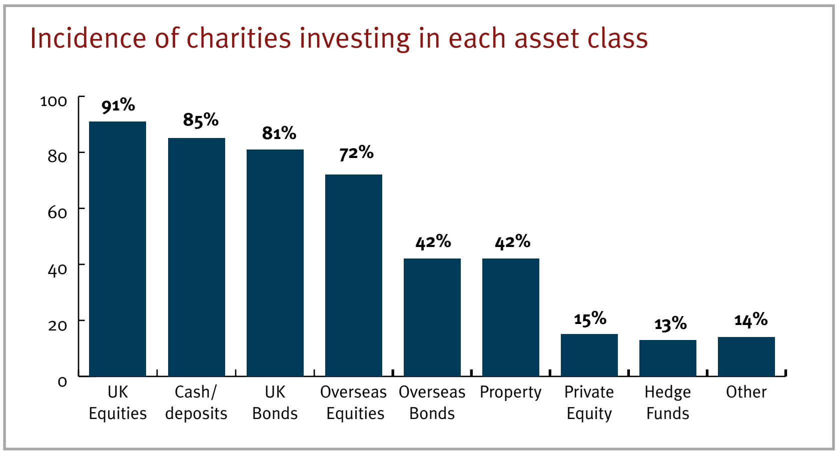
Given that more than half of charities have said that fundraising has become more difficult (see page 15), we can fairly assume that this reversal in fortunes is largely due to the recovery in stock markets. Between September 2002 and September 2003, the FTSE 100 index of leading shares rose by 10% whereas it fell -24% in the previous 12-month period.

Even so, a sizeable proportion of charities did not appear to share in the recovery, with 22% reporting a decline in asset value. Nine percent reported no change in the value of their assets.

The Findings:

How charity assets are managed (cont'd)

Asset allocation - where are charities investing



Nearly all charities surveyed had some exposure to UK equities and at least four out of five held UK bonds and short-term deposits/cash. The larger the charity, the greater the range of asset classes held.

Asset allocation has seen some noticeable developments since last year's survey. The percentage of respondents with exposure to overseas equities and overseas bonds has increased from 62% to 72% and 33% to 42% respectively.

Meanwhile, the number of respondents using hedge funds has more than doubled from 6% to 13%.

Comment

Increased ownership of overseas equities and bonds suggests that charities are looking further afield to generate investment returns. Given recent difficult market conditions – during which many charities may have been tempted to 'stick to what they know' – it is heartening for the asset management industry to have evidence that charities are seeking out new sources of return.

Hedge funds are still the least used asset class among charities. But the fact that double the number of charities are using them compared to a year ago (6%) is noteworthy. Greater education, widespread media coverage and the phenomenal returns reported for hedge funds over the past two to three years are clearly having an impact.

Changes to asset allocation in response to market environment

We asked charities how volatility in equity markets had affected their asset allocation decisions. This question was also asked in last year's survey and we have compared responses from the two years' surveys below.

Many charities are still paring back risk in their asset allocation. In this year's survey, just over a third of respondents had reduced their equity allocation and increased their exposure to bonds and/or cash.

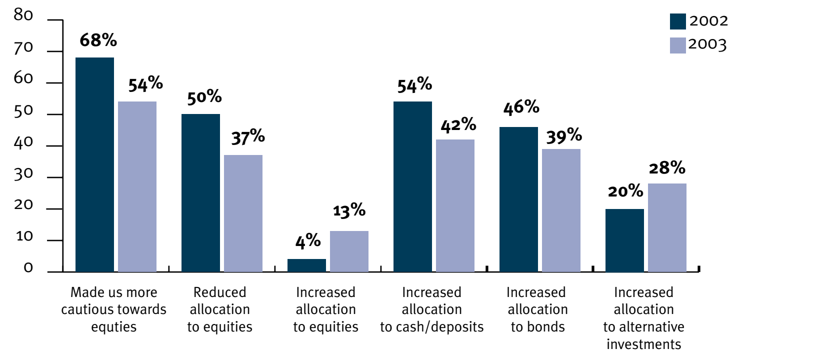
However, this percentage is considerably smaller than it was in our 2002 survey in which more than two-thirds (68%) of charities said they had reduced equity exposure.

At the same time, the percentage of charities increasing equity exposure has tripled from 4% last year to 13% in this year's survey. Exposure to alternative investments has also seen a notable rise, with over a quarter of respondents increasing exposure to asset classes such as property, private equity and hedge funds.

Comment

These asset allocation findings consistently indicate that charities are recovering their risk appetite, with more of them increasing exposure to equities and fewer increasing exposure to bonds and cash. The recovery in equity markets after the low point of March 2003 has undoubtedly affected investment decisions.

How volatile equity markets have affected asset allocation



The Findings:

Attitudes towards pooled fund investment

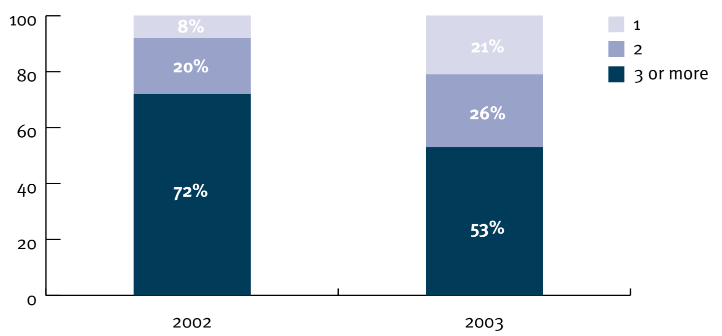
Pooled investment trends

Pooled investment is growing in popularity among charities. Just over half (56%) of the charities surveyed use pooled investment funds and 25% use pooled funds exclusively (i.e they use no segregated management).

As we note on page 4, this marks a significant increase in the use of pooled funds since our first Charity Investment Industry Survey in 2001.

There also appears to be an increase in the average number of pooled fund managers used by charities. A year ago, 72% of pooled fund users only employed one fund manager; this percentage has now dropped to 53%. One in four (26%) pooled fund users employ two fund managers and one in five (21%) use three or more. Our research also shows that the larger a charity is, the more likely it is to use multiple managers.

Number of pooled fund managers used



Comment

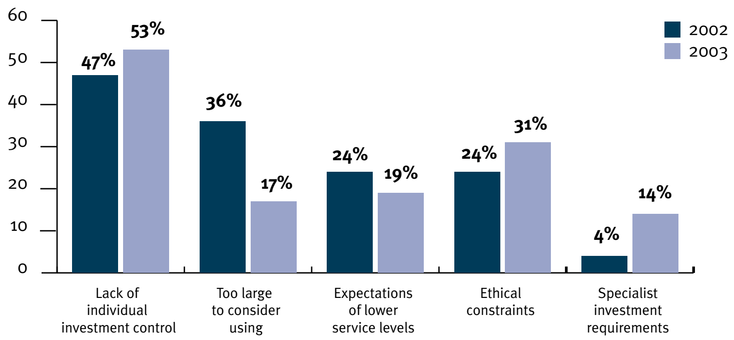
As the use of pooled funds increases, charities are becoming more discerning in their choice of fund manager and are more interested in combining a range of managers in order to take advantage of different specialisations and diversify performance risk.

Given that charities are looking more to esoteric asset classes such as overseas bonds and alternative investments like private equity and hedge funds to generate excess return, we would expect this multi-fund provider trend to accelerate. Conversely, there may also be a greater focus on large multi-discipline fund houses who can provide a range of specialisations under one roof.

Reasons for not using pooled funds

Although pooled fund usage is increasing, 44% of charities do not use them, preferring to manage their assets on a segregated basis. The reasons why these charities do not use pooled funds are shown in the chart below and have been compared to the reasons given a year ago.

Reasons for not using pooled funds



'Lack of individual investment control' continues to be the dominant reason for not using pooled funds. But there has been a sharp decline in the number of charities citing 'Too large to consider using funds' and 'Expectations of lower service levels'.

On the other hand, the proportion of non-pooled users citing 'Ethical constraints' and 'Specialist investment requirements' has increased.

Only a small minority (17%) of charities currently not using pooled funds would positively rule out using them altogether, a figure comparable with the 15% recorded in last year's survey. Most charities (66%) would keep an open mind and possibly consider using pooled funds in the future. A further 17% would consider using them provided their charity's ethical constraints would still be met.

The Findings:

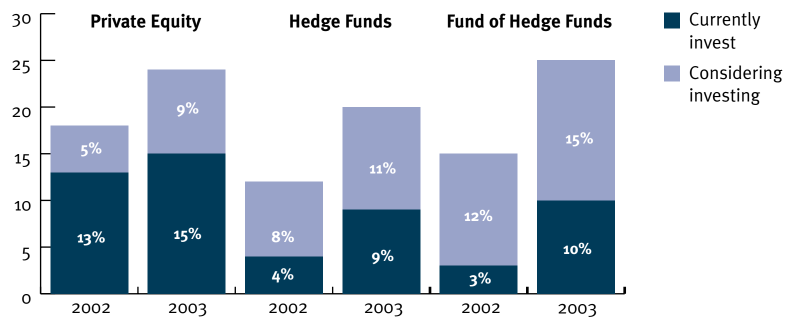
Attitudes towards alternative investments

Trends in private equity and hedge funds

Private equity and hedge funds have enjoyed greater attention from charities this year. The proportion of charities investing in private equity has increased modestly from 13% to 15%, with a further 9% saying they are considering private equity investment.

The increase in hedge fund exposure (which admittedly started from a lower base than private equity investment) is more marked, with the proportion of charities investing in hedge funds or hedge fund of funds more than doubling over the 12-month period to September 2003.

Incidence of investment in private equity and hedge funds



Among those charities who already have exposure, the majority increased their exposure to private equity and (particularly) hedge funds during the course of the year. Larger charities are the most inclined either to be investing in alternative investments or considering them.

Charities have also become better informed about investing in alternative investments during the course of the year. When we undertook this survey a year ago, around half of all charities surveyed did not feel well informed enough about private equity or hedge fund investments. In the latest survey, only a third of respondents felt they were not well informed about these asset classes.

Comment

Better understanding and strong recent performance has encouraged more charities to consider alternative investments. Hedge funds are a relatively new concept for charities to consider but the growth in interest in them has been marked. It will be interesting to see whether this momentum continues now that stock markets have stabilised and there may be less impetus for charities to generate returns through hedge fund tactics such as short-selling.

The Findings:

Socially responsible & ethical investing

Who applies SRI/ethical constraints

Almost half of charities surveyed (46%) said that they abide by socially responsible investment (SRI) or ethical constraints when investing. Churches, hospital-related charities and research institutions featured as the most likely to apply socially responsible or ethical constraints on their investment policy.

A further 8% of charities said that they intend to introduce a socially responsible or ethical policy, with half intending to do so within the next 12 months. These results are on a par with last year's findings.

Most common SRI/ethical constraints

Avoidance of companies involved in tobacco manufacture is the key ethical concern among charities and was mentioned by three-quarters of charities adopting a socially responsible or ethical policy. This was followed by avoidance of arms manufacturers (33%). Other industries excluded from investment include gambling, alcohol manufacture and pornography.

The vast majority (85%) of these charities operate a negative screening policy (i.e. the exclusion of particular companies/industries) rather than a positive screening policy (inclusion of specific companies). Only around 1 in 10 charities, which have a socially responsible or ethical investment policy use an external agency to screen companies, which is on a par with last year's results. Stock screening is carried out either by the charity's fund manager or Ethical Investment Research Service (EIRIS).

The number of charities benchmarking their returns against a Socially Responsible Investment Index was negligible. Only 8% did so, and a bespoke benchmark was used in all cases.

The Findings:

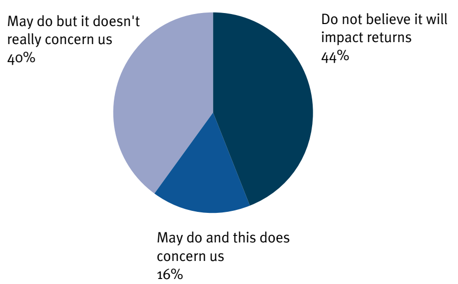
Socially responsible & ethical investing (cont'd)

Perceived impact of SRI/ethical investment on returns

When asked whether the restrictions imposed by an SRI/ethical investment policy were likely to detract from investment performance, charities are fairly evenly divided between those who believe it had an impact (56%) and those who didn't (44%). However, these figures do mark an increase since last year in the percentage of charities which believe that SRI or ethical constraints do have an impact on performance: in 2002, the figure was 42%.

But what is perhaps most interesting is that of those who believe that SRI/ethical policies may hold back returns, the vast majority say they are not very concerned by the fact. Only 16% of charities operating an SRI/ethical policy say they are concerned by the potential negative impact of their policy on investment returns.

Impact of an SRI/ethical policy on financial returns



Comment

Charities who adhere to ethical or socially responsible investment (SRI) considerations tend to prioritise these requirements above the need to generate strong investment performance. The fact that 44% of such charities do not believe that ethical or SRI constraints have an impact on returns hopefully suggests that good performance and ethical/social principles need not be mutually exclusive.

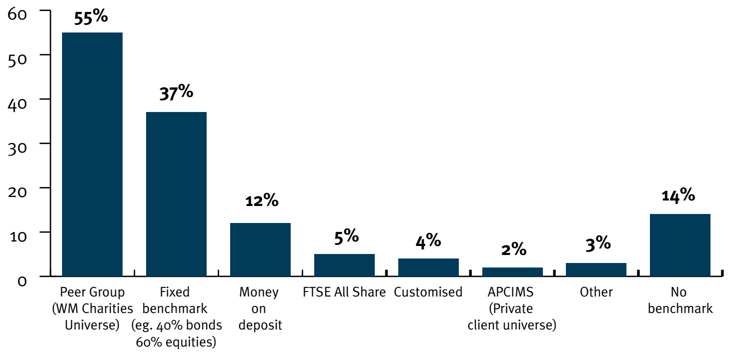
The Findings:

Stewardship of assets

Measuring performance

Most charities (88%) benchmark the performance of their portfolio, most commonly choosing to measure performance against their peer group as represented by the WM Company Charities Universe:

Benchmark used for charity portfolio



We asked charities whether volatility in investment markets had led them to review their benchmark. Nearly half (46%) of charities responded that it had or that a review was currently underway. Some of these charities reported that they had taken action in response to market volatility, such as moving towards fixed benchmarks, adopting a total return policy, lowering the benchmark target or capping equity holdings.

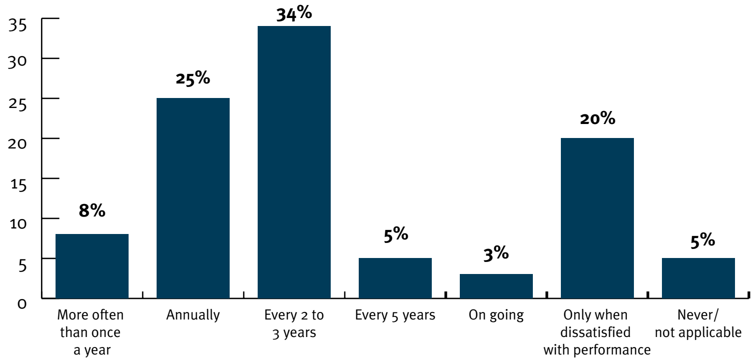
The Findings:

Stewardship of assets (cont'd)

Investment manager reviews

Charities vary widely in how often they hold a formal review of their investment manager. The majority undertake a formal review either annually or every two to three years, but a sizeable proportion (20%) only do so when they are dissatisfied with the performance of the incumbent manager. This pattern holds whether charities use segregated management or pooled fund management.

Frequency of formal reviews of the investment manager



Use of consultants

Our survey suggests that charities are increasing their use of investment consultants. Twenty-nine percent of charities used the services of an Investment Consultant in their last review, which is only slightly up on last year's survey (25%). However 43% of charities say they intend using a consultant at their next investment review.

The two investment consultants most commonly used are Cambridge Associates, followed by Edward Jewson Services, as was the case last year.

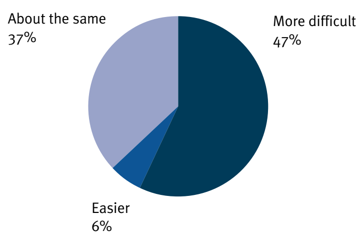
The Findings:

Pressure on fund-raising and income

Pressure on fund-raising

Around 1 in 4 charities surveyed do not operate fund-raising activities or they rely entirely on endowments for their funding. We asked the remainder who do undertake fundraising activities whether they had found the task easier or more difficult compared to five years ago. The response was as follows:

Difference in ability to fund-raise now compared with five years ago



Since our last survey, the proportion of charities finding it easier to raise funds has increased from 1% to 6%. However, this proportion is still tiny compared to the bulk of charities (57%) who said that fund raising has become harder over the last five years.

But views are polarised as to whether changes in the capital value of assets over the last five years have hindered charities from meeting their objectives. Fifty-two percent of charities surveyed say that it has (11% saying it has made a great impact), whilst 48% say that it has made no impact.

The Findings:

Pressure on fund-raising and income (cont'd)

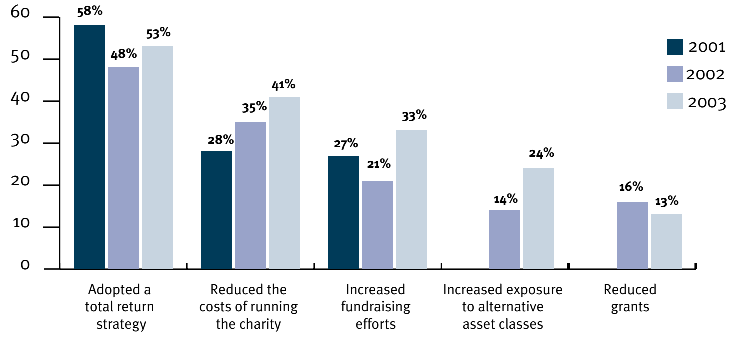
Pressure on investment income

What is clear is that charities continue to face greater pressure now on their investment income than was the case five years ago.

In the previous two years' surveys, two out of three charities said that they were facing greater pressure on their investment income than they were five years ago. In this year's survey, the proportion was identical which indicates that the situation has not got any better.

There are several ways that charities are reacting to the increased pressure on investment income, as the chart below shows:-

Reactions to increased pressure on investment income



(Some response options were not included in the 2001 survey)

Reactions to pressure on income

Just over a half (53%) of charities sampled said that they had adopted a total return investment strategy to help counteract the pressure on income which is consistent with our previous surveys.

Around 4 in 10 charities said that they had reduced the costs of running the charity, a figure which has increased considerably since our 2001 survey. A third said that they had increased fund-raising efforts to make up the shortfall. Other measures included reducing the size of grants made (13%) and investing more in alternative asset classes such as property, hedge funds and private equity. The proportion taking this latter action has risen from 14% to 24% over the last year.

Comment

Throughout the last three years that we have conducted this survey, the proportion of charities admitting to growing pressure on income has stayed steady at around two-thirds which at least suggests that difficulties for the sector have reached some kind of equilibrium. It is perhaps disappointing this year that only 6% of respondents have registered any clear easing in income pressures, given the recent stock market recovery. However, this may be understandable given that we are asking charities to compare their current situation with the bouyant environment in 1998 when equities were nearing the peak of the bull market.

In their own words

Charities voice their key concerns

In each Charity Investment Industry Survey, we ask respondents to give their key concerns about managing their charity's assets over the next three to five years.

Most comments centred on maintaining an income stream to meet outgoings whilst trying to preserve the capital value of investments. Many respondents simply responded 'Earning enough income" as their key concern. Other ad verbatim quotes are as follows:

"We need to restore the value of our portfolio while still maintaining a £2m spend."

"[We face] continuing income pressures particularly in the light of increased contributions required to keep our final salary pension scheme."

"[The challenge is] finding a reasonable approach to risk in terms of raising (or maintaining) our income without prejudicing the value and quality of assets."

"[We need to maintain] income levels to meet planned expenditure and preserve capital values for future developments in grant-making."

"We need to maintain [our] income base for annual expenditures. Other investments are very long term and need for sustained growth is essential."

The prospect of another bear market also remained a major concern, with many charities claiming they would need a fundamental review of investment strategy if another sustained downturn takes place:

"If the market turns down again we will need to look hard at our strategy and perhaps extend our asset classes."

"We need market stability to match income and charitable expenditure as we are totally reliant on investment income."

Many charities are also concerned whether the strong performance of the property sector can be sustained. One respondent talked about the importance of hedging against collapse in the property sector. Another referred to:

"the oversupply of commercial property for letting to 'blue chip' tenants".

Many charities are also keen to be able to hold fund managers accountable for performance and to be able to measure performance in a meaningful way:

"We need to get our benchmark right and make sure we have the right investment managers."

"{We are concerned that] the fund managers are performing as best they can within the constraints we have put on them."

"It would make sense for investment managers to manage actively to produce positive total returns rather than being concerned about beating benchmark returns."

"[We are concerned by the lack] of performance-related fee structures offered by investment managers."

"[Our key concern is] monitoring our investment manager to make sure they are in the right asset classes to benefit from an upturn in the market."

"[We are concerned by] the investment manager's capacity to manage strategic allocation...particularly in falling markets."

Finally, some charities were unequivocal about the investment return they need to achieve:

"The long-term view is to achieve a 7.5 % total return. We hope this will be achieved."

For further information about this survey or any aspect of JPMorgan Fleming's Charity Services, please contact:

JPMorgan Fleming Asset Management
Finsbury Dials
20 Finsbury Street
London
EC2Y 9AQ

Internet: www.jpmorganfleming.com/institutional
Tel No: 020 7742 6000

Katie Delacombe, Charities Relationship Manager
020 7742 5307
katie.j.delacombe@jpmorganfleming.com