



Subject Investment Strategy
Purpose For Decision
From Marc Stoner, Head of Finance and Resources

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1. Summary

Under the Scheme of Decision Making, the Board are required to set the strategy for its investments.

The Board at its September 2016 meeting changed its investment strategy by removing the requirement to grow capital with a lower to medium risk.

Following discussions with the Investment Broker and Internal Auditors it has become apparent that risk appetite and tolerance is the one item that is missing from the Board's revised investment strategy.

It is vital that the Investment Broker gains an understanding of the Board's attitude to risk in order to base his recommendation on the way forward. The hope is that this can be concluded at the November Board meeting where the Boards Investment Broker will be in attendance.

The Board is now asked to consider the recommendations outlined below to include the level of risk within its Investment Strategy.

2. Recommendations

It is recommended that the Board:

- i. Agrees the following Investment Strategy
 1. Protect the real value of capital
 2. Any growth within the capital should be with lower risk
 3. Maintain required liquidity

3. Open

4. Contribution to the Board's Purpose and Objectives

In delivering the Act, ARB's objectives are:

Protect the users and potential users of architects' services

Support architects through regulation.

To manage the organisation's finances prudently whilst delivering ARB's statutory requirements and objectives.

5. Background

- i. Specialist investment advice is provided to the Board by Quilter Cheviot Investment Management and managed on a day to day basis by Executive Director, James Malcolmson.
- ii. Prior to July 2014, the Board's attitude to risk, in relation to its Investment Strategy, was one of low tolerance. This meant investment was only in UK fixed income deposits.

At its July 2014 meeting, the Board advised its Investment Broker that its main priority was the preservation and growth of capital. The Broker advised that the Board should consider adopting a more flexible strategy as the current strategy was no longer low risk due to the vulnerability of interest rate rises, which were being speculated on in both the UK and USA.

The Board, at its meeting, changed its strategy in order to increase its diversification of the investment portfolio to include equities. This change in 2014 moved the Board's risk profile from Lower to Lower/Medium (an explanation of the risk categories is attached at [Annex A](#)).

- iii. At the July 2015 Board meeting the Broker presented his annual report to the Board, where he advised that the strategic change made by the Board in July 2014 had resulted in some additional growth. At the Board meeting a conversation took place as to whether there was any ethical criteria attached to ARB's investment strategy.

It was felt that while there are 'ethically clean' funds available, the Board has no ethical obligation to invest in such funds. The Board's priority remained the protection of ARB's capital, and any other considerations would remain secondary. In any event, ethical standards can largely be subjective. The Board agreed to make no changes to its existing strategy.

- iv. At its July 2016 meeting, as part of the Board's annual update with the Investment Broker, the Board had a discussion as to whether it should increase its risk tolerance; set targets for the Investment Broker to achieve; and whether it should go out to tender for future investment services. It was agreed that the Board's existing strategy should be maintained, pending the Operational Management Group undertaking further investigations into some of the issues raised during the meeting.
- v. At its September 2016 meeting the Board received an update on the matters raised at its previous meeting. It was reported the performance of the portfolio over the last five years had generated approximately £678k (25.2% return, net of commission and fees). During the last 12 months to 22 August 2016, the return was £278k (4.2% after commission and fees). The Investment Broker has also maintained his current management fee of 0.25%, which the Operational

Management Group (OMG) reported demonstrates value for money. The Board queried how ARB’s portfolio had performed under the Broker’s management over the last 10 years (to take account of the economic downturn). The overall performance of the ARB portfolio since November 2006 has been a return of £1,228k (64.5% after commission and fees).

- vi. It was also reported that research had been undertaken into other bodies’ investment strategies and with the Board’s Internal and External auditors. This research indicates that a fairly low risk strategy is common among regulators with some setting targets such as Consumer Price Index (CPI) + 2% or a return in line with inflation.
- vii. Also at its September 2016 meeting, the Board discussed a recommendation by its Investment Broker to diversify a portion of its current UK Equities to Europe and the United States (US).

The Board was advised that it would not increase the risk by going overseas, particularly into the US. It would reduce the risk by increasing the diversification and the reliance on the UK market. As an example, after the EU Referendum at the end of June, the UK market fell the two days before recovering and moving on to the current level. As we have 100% UK equity exposure we did not have the diversification to reserve capital in this short term downside that was experienced by the market.

The Board raised a number of concerns about Brexit and US presidential election uncertainties and its impact on the wider economy. The Board concluded that the Lower/Medium level of risk it had been taking in recent years was now too high in the current economic environment. It was agreed by majority that the strategy should be limited to protecting the real value of capital and maintaining liquidity.

Previous Strategy	Revised Strategy
4. Protect the real value of capital	1. Protect the real value of capital
5. Achieve growth within the capital, with lower to medium risk	2. Maintain required liquidity
6. Maintain required liquidity	

- viii. It was agreed that the Head of Finance and Resources would explore options with the Investment Broker, based on the revised strategy, and report back to the Audit Committee on the risks associated with the change and any potential options for lowering the risks. A report should then be bought back to the November Board meeting for final agreement.
- ix. Discussions have taken place with the Board’s Investment Broker and ARB’s Internal Auditors and further discussion was undertaken at the Audit Committee meeting in October and comments have been considered and factored into this

report.

x. **Findings**

In aligning the Board's portfolio with its revised strategy, the following information has been gathered and is based on discussions with the Investment Broker and the Internal Auditors. However, this should not be taken as formal investment advice as the formal advice can only be provided by the Board Investment Broker who will be in attendance at the November Board Meeting.

xi. ***Holding Cash***

The lowest risk possible comes from simply holding cash. We would need to open accounts with individual financial institutions which would each offer protection of £75k should the institution fail. In ARB's case, with its current portfolio of between £5m and £6m, that would mean identifying and managing approximately 75 accounts with different financial institutions.

Given the low rate of interest (if any at all) that would be achieved, it would be unlikely to meet the first objective of the Board's strategy 'To protect the real value of capital'. Holding so many bank accounts would increase the financial risk for the Board, as business accounts come with charges, which in the current economic environment will likely outweigh the interest generated, therefore reducing the investment's current value. It should however be noted that this market has not been tested.

The Board may face reputational risk through the form of criticism for holding cash when we have inflation in the economy and thereby failing to appropriately manage its financial resources.

xii. ***Indexed-Linked Sovereign Debt***

In order to attempt to protect the real value of capital, a higher risk approach to simply holding cash must be taken.

This higher risk approach would be in the form of holding indexed-linked sovereign debt.

This type of bond is issued by the Debt Management Office on behalf of the Bank of England or indeed the Government when it needs to raise funds. Therefore, they have the security of being backed by the Bank of England and therefore form less or the lowest level of risk.

The way they operate is they are correlated with the Retail Price Index (RPI) – that is inflation. They are not correlated with CPI (Consumer Price Indices) which it can sometimes be confused with; this is a lower figure and excludes energy, insurance and local taxes.

The key risk to these types of investments appears to be deflation which would erode the capital. While the current economic forecast (see forecast in [Annex B](#)) doesn't indicate a risk of deflation, it is nevertheless a risk factor. The Board's Broker monitors the economy and will flag any increase in the risk due to deflation, recommending any changes to the portfolio to be approved by the Head of Finance and Resources.

The Broker's reasoning behind this is: *The recent CPI figures saw a rise of 0.6% year on year, whilst RPI showed an increase of 1.8% year on year. RPI is what needs to be worried about as it is the actual inflation in the economy considering all factors and index-linked are correlated with RPI not CPI. It also means that by holding cash, which is a potential option, your buying power is eroded.*

ARB currently holds around 18% of its portfolio in these types of funds. It also holds around 16% of its portfolio in other fixed interest Gilts.

xiii. **Corporate Bonds**

ARB holds a number of high rated Corporate Bonds that are producing a greater return than Indexed-Linked Sovereign Debt. These will yield 2 to 2.3% in addition to the potential for capital return, as interest rates have fallen historically.

It should be noted that Corporate Bonds are dependent on market conditions, but importantly they offer a different return to that of Index-linked. By holding these two classes of investments (Index-linked and Corporate Bonds) risk is reduced through diversification.

The main risk in holding this class of investments is that it is vulnerable to an interest rate rise, so consideration needs to be given to the risk of future interest rate rises as and when they may occur. The Board's Broker monitors the economy and will flag risk due to interest rate movements within the economy and raise any increase in the risk. The Broker recommends changes to the portfolio which are approved by the Head of Finance and Resources and Registrar Chief Executive.

ARB currently holds around 36% of its portfolio in these types of bonds.

xiv. **Equities**

It was evident from the comments of some Board members at the September 2016 Board meeting that these types of investments are outside of the Board's attitude to risk as they were considered high risk and volatile. Concerns were raised around currency fluctuations and the US Presidential Elections. The Broker has confirmed that he had factored in these considerations before making his recommendation of diversification of the Equities portfolio.

ARB has historically held some equity exposure in the form of funds (investment and unit trusts). These have been held on purpose, as opposed to direct equities, to give greater diversification and reduce the risk which will also curtail the scope

for upside appreciation, yet remaining within ARB's risk tolerance.

ARB has already, raised some cash from the equities anticipating the Board's move to 'de-risk' the portfolio. At present we are holding just under £950,000 in cash, which has reduced the equity exposure from 30% down to 13.2%.

In order to lower the risk (currently sits at Lower/Medium) the Board needs to consider withdrawing completely from this investment type class by selling its remaining equities.

xv. ***Tendering/Market Testing***

Having discussed the timing of undertaking a tendering/market testing exercise with the Internal Auditors, it is proposed that testing the market is not undertaken until the Board has an agreed investment strategy.

Consideration will need to be given as to the type of service we would need to be procuring from an adviser given that most of the portfolio may end up being highly concentrated on Index-linked sovereign debt. This would give very little scope to test the market against, apart from the actual fee.

xvi. ***Liquidity***

Index-Linked investments are one of the most liquid asset classes to invest in and so a high exposure to this area would not cause problems in relation to liquidity, particularly as they will be Sovereign rather than Corporate Index-linked.

ARB currently invests funds that are not required for around 6 – 8 months. This will be dealt with at an operational level and will also be taken into consideration by the Broker prior to making any investment changes.

6. Resource implications

In order to implement the Board's revised investment strategy, funds will be sold for either cash flow purposes or when they are achieving a high market value. This will help reduce financial impact on the overall value of the funds, which would be the same approach as we operate in the day to day management of these funds.

7. Risk Implications

Prior to the change in strategy at its September meeting, the Board's attitude to risk was Lower to Medium in relation to its investments. This is achieved through having a diverse portfolio of investments as recommended by the Board's Investment Broker.

The Board could be criticised by holding so much cash on deposit where the current returns are negligible and also eroded by inflation particularly with the outlook for a further cut in UK rates being flagged up by the Bank of England.

There is obviously risk in any form of investment but an element of risk should be

considered by the Board in order to achieve a return beyond being experienced by simply holding cash. Therefore, it is suggested that the Board should consider aiming to achieve a smaller return than it had previously by setting the level of risk to 'Lower'. This will take the Board back to its level of risk prior to 2014.

It is important that the Board gives a clear direction to the Broker as to its attitude to risk; the suitability of the different type of investments available; and its capacity for loss.

Given the Board buys in its investment expertise, it should be guided by the advice of the Broker, unless it feels it has a valid reason not to do so and requires further advice.

8. Communication

ARB is committed to seeking cost-saving initiatives to help ensure value for money balanced with prudent management of ARB's financial resources contribute towards maximising cost savings.

9. Equality and Diversity Implications

None currently identified.

10. Further Actions

It seems clear that a further move out of equities will lower the Board's current risk of Lower/Medium to Lower.

Whilst considering the Board's objective of protecting the capital with a lower risk approach, The Broker recommends the following proposals:

- 1) Sell the ARB's remaining equity exposure, thereby reducing the investment strategy to lower risk;
- 2) Reduce ARB's holding of corporate bond funds in order to meet the proposal as far as the asset allocation is concerned. When interest rates move, the capital value is likely, with corporate bonds, to fall and understandably will become vulnerable as a result, at which time this investment category will be revisited.

The revised portfolio would look something like:

Index-linked Sovereign Debt (70% to 75%) of the portfolio
Corporate Bonds (25% - 30%) of the portfolio