

# 123 Trust Fund

## Ensuring the protection in perpetuity of the world's last sites to avoid extinction

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### 1. Investment structure

The 123 Trust Fund ("the Trust Fund") will be a long term financing vehicle established by XYZ Foundation, a registered charity, to provide long term financial support for the reserves and administrative overheads of Fundación XYZ de Colombia.

#### i. Financial Structure

Legally the Trust Fund will be a restricted fund within XYZ Foundation, accounted for and invested in pounds sterling. Its initial target capitalization will be US dollars \$1.5 million, to support a long term annual budget of c. \$75,000 and a long-term capitalization rate of c.5%.

Internally, the fund will be divided into two parts, a distribution fund and a capital fund. The distribution fund will consist of 15% of the initial and subsequent injections of capital into the Trust Fund, and the capital fund of 85% of the initial and subsequent injections of capital into the Trust Fund.

The distribution fund and the capital fund will be pooled for investment purposes by XYZ Foundation. The objectives of this structure are:

- a) To allow the investments of the Trust Fund to be managed with the objective of maximizing long term total return (income plus capital growth), without inhibiting the ability of the Trust Fund to support Fundación XYZ de Colombia during periods of poor investment return.
- b) To protect at least 85% of the real (i.e. after allowing for inflation) value of the capital of the Trust Fund from being spent.
- c) To always allow in each year at least some limited funds to be available to be spent to support Fundación XYZ de Colombia.
- d) To provide a mechanism to target that the total value of the preserved capital fund should match the real value of the initial and subsequent injections of capital into the Trust Fund should the investments of the Trust Fund prove successful in the long term.

However, it is not anticipated that the full budget will be required in the early years, and the long term target is to achieve a conservative capitalization rate of 4.25%-5% of the conservation budget (see investment policy) .

#### ii. Capital Fund

All investment returns whether positive or negative will accrue to the Capital Fund. Each year if the total investment return is positive an amount will transferred to the distribution fund being the lower of:

- a) 75% of the real investment return, being defined as the cumulative investment return since initiation less such amount as the committee deems necessary to maintain the real value of initial and subsequent injections of capital into the Capital Fund
- b) An amount sufficient to make the distribution fund 20% of the total Trust Fund.

#### iii. Distribution Fund

Up to 25% of the distribution fund can be earmarked each year by the investment committee for payment to Fundación XYZ de Colombia, with transfers to the Expense account being made from this earmarked amount at the request of the Trustees (not the investment committee) in accordance with the agreement with GCF, and from the expense account to Fundación XYZ de Colombia. Should some of the amount earmarked not be used in a particular year, the amount earmarked for the subsequent year can be increased by up to 75% of the amount unused the previous year (which together with the 25% by which the distribution fund will have increased from the earmarked amount not being spent totals 100%).

#### iv. Investment policy

The investment policy of the Trust Fund will aim to maximize the long term return of the fund primarily by capital growth. The objective of is achieve an average annual return of 6.25%-7%, i.e. 4.25-5% after inflation. Whilst this return is below that which might be expected to have been achieved on average in

recent years, it is not considered realistic to target a return in the long term of greater than 7% nominal (5% real assuming 2% inflation).

Indeed the long term target is to aim for a capitalization rate of 4.25% of the conservation budget, consistent with the lower end of targeted annual returns. We expect to achieve this through a successful long term investment policy combined to a lower rate of distribution in the earlier years.

The short-term financial position of Fundación XYZ de Colombia is relatively healthy. However there is a particularly severe long term problem of assisting a growing organization in a country that is experiencing a high rate of economic growth that may lead to inflationary cost pressures of salaries beyond the general rate of inflation. The theory of purchasing power parity suggest that the long term effects of differential inflation and exchange rate fluctuations should be neutral, but they create considerable medium term uncertainty, and the improving security situation in Colombia may also lead to further real appreciation in the currency.

Taking into account the particularly strong long-term need for funds compared with short term, and the particular mechanisms proposed for the Trust Fund to cope with short term fluctuations in investment returns, we propose a maximum equity exposure of the portfolio of 75% compared with the usually recommended 60%.

With long term UK government bonds yielding around 4%, then an equity risk premium of 3-4% should allow a return of 7-8%. Assuming a mix of 75% equities and 25% bonds, a long term average return of 6.25%-7.0% is achieved. Even to achieve this it is necessary to accept that in some periods total investment return may be negative, although in recent years we would have expected to have achieved a higher return than this.

Whilst it is the intention of the investment committee to invest primarily in equity-based investments, given the size of the fund (less than one million pounds) and the desirability of a low degree of investment turnover to minimize transaction costs, it is intended to invest for long term value in open and closed-end funds that on aggregate (although not necessarily individually) have a risk profile less than the UK equity market as a whole, rather than investing directly in equities.

Part of the fund (25%) will be held in UK or other government bonds, probably directly but possibly by a bond fund. Given that the purpose of holding part of the portfolio in bonds is to reduce the risk profile of the overall return, maturities of 5-10 years would be targeted rather than very long bonds which have a higher capital risk. Yields on these maturities are currently in the region of 4.1%.

It is envisaged that most of the Trust Fund (75%) will be invested in equity related investments, primarily focusing on the UK equity market given that most UK-based funds are benchmarked against the FTSE All Share Index. Whilst the possibility of investing in individual equities is not completely precluded, it is the current intention to obtain the necessary degree of risk diversification by directly purchasing a relatively small number (4-8) of closed end funds (investment trusts). These have proved an excellent investment vehicle in recent years due to their lower fee structures than open-ended funds (unit trusts) and the possibility to purchase funds on small discounts to the underlying assets, with the narrowing of the discount over time often offsetting or exceeding the underlying management fees within the fund.

For those not familiar with how investment trusts operate in the UK the following link shows a useful article: <http://www.trustnet.com/general/news/display-story.asp?id=74649&db=educational>

Particularly taking account of the fact that the long term expenses of the fund are linked to an economy that is closer to the dollar than sterling, the committee will seek to obtain a degree of overseas exposure through appropriate funds that invest in Europe, the US or other overseas markets. It is not envisaged that the Trust Fund will make any direct investments in real estate and/or venture capital, but the committee may well consider the possibility of investing in one or more funds specialising in real estate and/or venture capital to obtain a diversified exposure to this area.

The trustees have discussed the possibility of an ethical investment policy particularly considering the environmental objectives of XYZ. Whilst there is no intention to invest directly in any companies a significant part of whose activities would be directly in contradiction to these objectives, it is inevitable due to the intention to seek diversification through closed end funds that the underlying investments of these funds will include companies of which some environmentalists might disapprove of at least part of their activities.

The trustees consider it desirable to attempt to include at least one fund in their portfolio that has an ethical environmental investment policy, ideally one that invests in companies that make a positive contribution to the environment rather than just avoids companies whose activities in considers unethical . However we have only been able to identify a small number of such funds, and it appears that some of them have very high underlying charging structures.

At this stage the committee is not therefore prepared to definitely commit to any specific ethical investment policy, beyond the intention to avoid direct investment in particularly undesirable companies, as it considers that the maximization of long term investment returns is of paramount importance.

## **v. Restrictions on Investments**

All investments shall be in US dollar, pound sterling or euro denominated instruments.

Allowable investments:

- Money market funds
- Government bonds issued by the UK, US or EU governments
- Open or listed closed end investment funds investing primarily in listed equities (maximum 75% in aggregate, 15% individually)
- Open or closed end investment funds investing primarily in real estate or venture capital (maximum 20% in aggregate, 10% individually)
- Open or closed end funds investing primarily in government or corporate bonds (maximum 50% in aggregate, 15% individually)
- UK, US or EU Listed equities (other than funds) with a market capitalisation greater than £500m (maximum 25% in aggregate, 5% individually)

Prohibited investments:

- Options
- Futures
- Hedge funds
- Short sales
- Margin transactions
- Commodities and futures contracts
- Split capital trusts
- Land
- Securities whose issuers have filed a petition for bankruptcy
- Other investments which are either not permitted to be made by XYZ Foundation or in relation to which the tax benefits enjoyed by XYZ Foundation as a charity are not available.

## **vi. Banking and Investment Account Arrangements**

At present, XYZ Foundation holds two bank accounts, one with the Charities Aid Foundation (CAF Bank), which holds the funds designated for the Trust Fund and earns interest, and one with Barclays Bank which is essentially a petty cash account.

Once the Trust Fund is established the CAF account will become part of the Trust Fund and be ring-fenced for this purpose.

The Barclays current ordinary bank account will be used as a transmission mechanism for payments used to finance Fundación XYZ de Colombia in accordance with the agreement of the GCF.

A savings account will also be opened with the designated broker, which we currently intend should be TD Waterhouse (part of TD Bank Financial Group formerly know as Toronto Dominion Bank). TD Waterhouse

would also be used a broker for the purchase and sale of funds and government bonds. Of the major brokers which offer an efficient on-line service TD Waterhouse appears to be the only one that offers an account especially for trusts of this nature, see:

<http://www.tdwaterhouse.co.uk/productsandservices/trusttrading.cfm>

Of the large UK-based online brokers that provide low-cost broking facilities, TD Waterhouse appears to be the only one that offers specialist accounts for charitable trusts. It also offers a savings account paying 4.3% interest.

Typically it is envisaged that the investment committee will realize investments or retain income in order to meet the anticipated requests of the Trustees to transfer funds into the Barclays account for onwards transmission. However funds will not be transferred until required, to maximize interest income.

## vii. Taxation

As a UK registered charity XYZ Foundation is exempt from UK taxes on income and capital gain. Approved unit and investment trusts in the UK pay do not pay tax on their capital gains, but do on their income after expenses or distributions, which is why they invest primarily for capital growth. Charities do not pay tax on government bonds.

## viii. Example of Capital and Distribution Fund Mechanism

The example below shows how the capital and distribution components of the Trust Fund would grow over time achieving an investment return of 7%. Allowing for 2% inflation then the initial fund of \$1.5m (£857,000 at \$1.75=£1) will only allow enough income to initially support 75% of the reserve administration budget of Fundación XYZ de Colombia. However the retention mechanism will allow this proportion to gradually increase to 91% over 10 years. An investment return of 8% would however allow for 100% of the budgeted (adjusted for inflation) to be financed from the Trust Fund within 10 years.

**Table 4:** Example of Capital and Distribution Fund Mechanism

Year	1	2	3	4	5	6	7	8	9	10
Opening total fund										
Investment return										
as %										
Real investment return										
<b>Capital Fund</b>										
<b>Opening Capital Fund</b>										
Investment return										
<b>Subtotal</b>										
Transfer to distribution fund										
<b>Closing Capital Fund</b>										
Capital target										
Fund as % of target										
Minimum capital fund										
<b>Distribution fund</b>										
Opening funds										
Distribution to expense account										
Transfer from capital fund										
<b>Closing</b>										
<b>AZE reserve budget</b>										
<b>\$'000</b>										
<b>£'000</b>										
% of budget met from TRUST FUND										

**ix. Notes:**

- a) The total long term fund is the total amount invested including both the capital and distribution component
- b) An investment return of 7% per annum is assumed
- c) The real investment return is after allowing for inflation at 2% per annum, the UK government's official target.
- d) The capital fund cannot be used under the agreement with GCF to meet reserve running costs
- e) Up to 25% of the distribution fund can be earmarked each year by the committee for payment to Fundación XYZ de Colombia, with transfers to the expense account being made from this earmarked amount at the request of the Trustees (not the committee) in accordance with the agreement with GCF.
- f) Initially 85% of the Trust Fund is allocated to the capital fund and 15% to the distribution fund, hence the transfer to expenses account shown in year 1 is 3.75% of the fund (25% of 15%).
- g) The transfer to the distribution fund each year is the lower of 75% of the excess of the capital fund over the minimum capital fund and such an amount as will make the distribution fund 20% of the total trust fund
- h) The minimum capital fund is 85% of the initial trust fund (and any subsequent additions) adjusted for inflation
- i) The target capital fund is 100% of the initial trust fund (and any subsequent additions) adjusted for inflation
- j) When the target capital fund is achieved the distribution fund will equal 20% of the target fund, and the amount that can be earmarked each year will be 5% (i.e. 25% of 20%) of the target capital fund, providing 100% of the projected reserve administration budget.
- k) All amounts are rounded to the nearest £1000, so the illustrative table may not compute exactly due to rounding.