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Happy New Year! What a year 2016 turned out to be; full of surprises and excitement. Some of the uncertainties around, for example Brexit, will have implications for the sector. Time will tell, but inevitably the uncertainty itself is not a good incentive for the donors and fundraisers alike.

It will take the next couple of years for the influence of uncertainty of war, terrorism, Brexit, etc., to show their full impact on the sector. It is by being vigilant and proactive that the sector may be in a position to whether the forthcoming storms.

Please note that the views expressed in this publication are those of the authors and not of Deloitte. In the complicated environment in which we all operate, always seek professional advice specifically and don't rely on contents of articles that have been written for general guidance only.

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Navigating the post-Brexit economic landscape

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Following the UK's vote to leave the European Union (EU), Christopher Metcalfe, lead manager of the Newton Growth & Income Fund for Charities, explores the outlook for different asset classes and looks at the investment implications for charities.

The historic outcome of the UK's June 2016 referendum on European Union (EU) membership was a shock to the financial system. On the day of the result, sterling experienced the largest daily range in its history, and has since been languishing at three-decade lows against the US dollar. However, while stock markets suffered substantial initial losses, they soon rallied, as investors appreciated the significant overseas earnings generated by its constituent companies. Global stock markets have since continued to make significant gains after policymakers stepped in to offer further support.

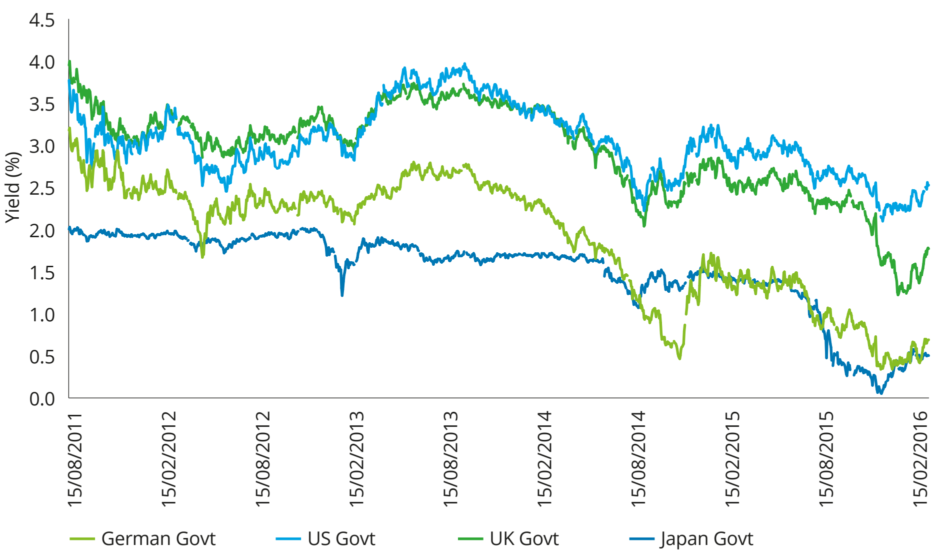
The subsequent victory of Donald Trump in the US presidential election in November, along with the 'no' vote in Italy's constitutional referendum in December, suggest the Brexit vote was not a one-off but reflective of a broader global trend, with electorates ready to express their discontent with the effects of globalisation and desire for a different approach.

Looking ahead, the shift to a more insular, domestically focused policy agenda in the US could further challenge globalisation. In addition, 2017 will see elections in the Netherlands and France, where, respectively, the far-right Party for Freedom and the National Front (which both take an extreme negative stance on immigration and the EU) hope to capitalise on populist sentiment following Trump's election in the US.

What is next for monetary policy and bond markets?

The Brexit vote came at a time of unease about the effectiveness of monetary policy – a concurrence that presents challenges to investors, given the part played by policymaking in underpinning financial-market recovery in the years since the global credit crisis of 2008. Ultra-low interest rates and other effects of this policymaking have presented significant challenges to bond[1] investors in recent years, with 'risk-free' yields[2] falling to new lows.

Exhibit 1. Government bonds – 10-year redemption yields
Long-dated government bond yields



Source: Thomson Reuters Datastream, December 2016.

1 Bond: A loan of money by an investor to a company or government for a set period of time, in exchange for a fixed interest rate and the repayment of the initial amount invested at its conclusion.

2 Bond yield: The amount of return an investor will realise on a bond.

However, recent moves by the European Central Bank, the Bank of Japan and others into the uncharted territory of negative interest rates, and the crowding out of investors from the bond markets, suggests that such an approach may be becoming counterproductive. Meanwhile, the US Federal Reserve decided to raise short-term interest rates in December, and has forecast a faster pace of tightening over 2017.

It is also becoming increasingly clear that politicians are looking to try a different tack to drive economic growth: fiscal stimulus. Investors' expectations of such an approach were in evidence following the Trump's election victory, when bond markets and 'bond proxy' equities were the victims of a sell-off, while those stocks thought likely to be beneficiaries of increased infrastructure spending and rising interest rates moved sharply higher.

Past performance is not a guide to future performance.

Such a move towards fiscal stimulus is a significant change from the predominantly loose monetary/tight fiscal policy that has been in place, and as such we expect it to have an upward impact on bond yields. However, this may be offset in the longer term by the deflationary trends of demographics and the significant debt that has built up around the world.

In the UK, while there are inflationary pressures building owing to the devaluation of sterling, this is having the effect of reducing the money in people's pockets while the cost of debt is going up. This is likely to challenge growth, rather than provide a longer-term inflationary impulse. With the Government's Autumn Statement doing little other than admitting that the government will not tighten fiscal policy in the face of the expected weaker GDP growth post-Brexit, there is unlikely to be a dramatic need for tighter UK monetary policy. If anything, the scope for Brexit-related uncertainties and further political challenges in the Eurozone in 2017 suggests that the bias in UK monetary policy is likely to remain easy over the next 12 months.

Equities – care is needed

After years of central-bank intervention, we believe global equity valuations – at almost 16 times prospective earnings in December 2016 – are sufficiently high to make a cautious assessment appropriate. While the mining and resources sectors have rallied following Donald Trump's election as US president, we think that the markets may have overestimated the pace and the extent of the impact of increased fiscal spending. In addition, we think the growing debt burden is another cause for concern, particularly the speed of debt accumulation in China, where many have seen a restocking of resources in 2016 as a sign of continuing strength.

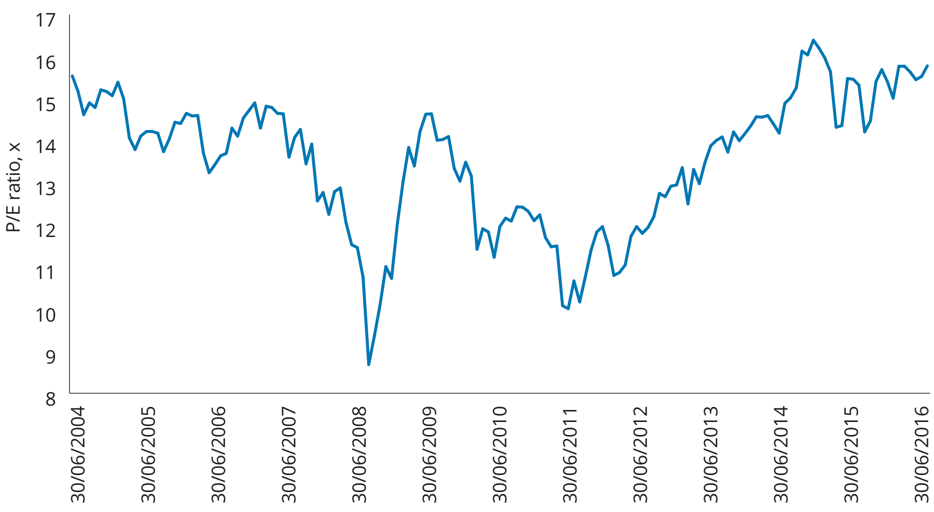
In the UK, the financial services sector is under pressure, which we do not see alleviating any time soon. Post-Brexit, there are huge uncertainties concerning the 'passporting' of products and services, an EU practice that has enabled London to become a leading financial centre.

However, we would temper the doomsayers on this point: financial services are a key UK offering and we question if companies are really going to relocate. Irrespective of the UK's membership of the EU, London remains a highly skilled area for financial services, with the breadth of language skills, real estate and infrastructure to support it, and few cities can compete.

Continuing sterling weakness could prove beneficial for equity-income investors. Some 40% of UK dividends[3] are declared in US dollars, so a sharp, sustainable depreciation in sterling boosts dividend payments for UK investors. As a result, the Q2 Capita Dividend Monitor, updated for Brexit, expects underlying dividends in 2016 to be up 0.5% owing to the exchange rate boost versus an expected decline of 1.7% pre-Brexit. With respect to dividend growth, we believe it still looks stable and, while it may slow as 2017 progresses, distributions still look robust.

Another benefit of lower sterling may be an increase in merger and acquisition (M&A) activity. For example, 2016 saw Japanese company SoftBank bid for the UK's ARM holdings, while US media corporation 21st Century Fox recently made an offer for Sky.

Exhibit 2. Global equity valuations



Source: Thomson Reuters Datastream, December 2016. The P/E ratio (price-earnings ratio) is the ratio for valuing a company that measures its current share price relevant to its per-share earnings.

3 Dividend: A sum of money paid regularly (typically annually) by a company to its shareholders out of its profits (or reserves).

Pressure on property

An asset class which may prove vulnerable in the aftermath of the Brexit vote is UK property. The market, particularly in the southeast of England, has benefited from the availability of cheap finance, the search for yield and demand from overseas investors. However, there have been a series of negative shocks through tax changes, higher burdens on foreign ownership (in terms of both tax and more onerous disclosure requirements), the rise and impact of internet shopping on retail and, most recently, the Brexit vote. These changes in the property market, coupled with low growth and increased taxation, could put pressure on the asset class.

Caution advised

We have for some time argued that a combination of factors has warranted a relatively cautious investment approach, namely high asset valuations, a challenged outlook for corporate profits, and increasing evidence that 'unconventional' monetary policies do nothing more than provide a short-term sugar rush to economies.

In the uncertain environment following the Brexit vote, we believe charities are likely to benefit from a global investment outlook. A focus solely on UK investments – or indeed on any single geographic area – is potentially detrimental when viewed through the prism of long-term returns. Furthermore, we believe portfolios with a focus on companies with stable cash flows,[4] low capital[5] intensity and durable business models not dependent on the economic recovery should be better positioned to provide consistent and sustainable returns, even during market downturns.

While returns from traditional assets remain suppressed, investors may be attracted by those investments that promise higher yields. However, there is a need for great selectivity when researching income opportunities.

Liquidity,[6] particularly within commercial real estate and the bond markets, is an additional concern, and charities should be aware of exposure to narrow 'exits' in illiquid markets. Following Brexit, a high level of redemptions in commercial property funds forced certain funds to 'gate in' investors while they sold some of the underlying property investments, potentially at distressed prices, to raise capital.

Against this challenging backdrop, we believe an emphasis on traditional asset classes and a deep understanding of what you own and how those assets are likely to behave in different market environments is crucial. At Newton, fundamental research by our global industry analysts and portfolio managers allows us to try to focus on investments which not only offer strong financial positioning, good management and attractive valuations, but which also benefit from favourable long-term trends. The headwinds created by collective debt burdens and ageing demographics, and by the disruption from rapid technological change, imply that consistency of cash flow generation, strength of balance sheets and pricing power, and flexible cost bases are likely to remain positive investment attributes. To our mind, the UK's vote to leave the EU merely adds to the importance of these characteristics in investment selection.

Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.

1 Cash flow: The total amount of money being transferred into and out of a business, especially as affecting liquidity.

2 Capital: Financial assets or the financial value of assets.

3 Liquidity: The extent to which an asset or security can be quickly bought or sold in the market without affecting its price.

The Common Reporting Standard: Autumn Update Overview

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The Common Reporting Standard (CRS) introduces reporting requirements for UK charities which earn the majority of their income from investments.

HMRC have recently released guidance to help charities meet their obligations. This provides detailed guidance regarding what due diligence and reporting activities charities will have to undertake in respect of their beneficiaries.

Charities which fall into scope need to act now to be ready for the first reporting deadline of 31 May 2017.

Background

This summer's edition of PULSE analysed the introduction of the CRS, and the potential administrative burdens it could bring to charities who fall within its scope. CRS was introduced as an international extension of the US focused Foreign Account Tax Compliance Act (FATCA) and required all entities within its scope to report any cash distributions made overseas. Whilst not being their main target, certain charities will fall within the CRS regulations, resulting in mandatory reporting regarding the tax compliance of their 'account holders' and the recipients of funds which have been transferred overseas.

Under CRS, a charity may be in scope when it is regarded as a Financial Institution. Charities may be regarded as Financial Institutions if they fall within the definition of an Investment Entity, and hence be subject to additional due diligence and reporting requirements.

A charity will qualify as an Investment Entity if it meets the following tests:

1. The financial assets of the charity are managed, in whole or in part, by a Financial Institution
2. Half or more of its gross income is attributable to investing, reinvesting or trading in financial assets.

HMRC's initial guidance for charities was basic and merely outlined that charities may be subject to the regime; however, more detailed guidance has recently been issued, intended to assist charities in understanding their reporting responsibilities in respect of the regime.

Although many charities may not be within the CRS regime, certain charities in receipt of income from investments, as a key income stream, should carefully consider how they may be affected. Larger national charities, in particular, should ensure appropriate consideration is given to the CRS regime and what response is required.

Ken Chan, Associate Director at Deloitte comments that: *"Under FATCA, charities enjoyed a blanket exemption from any due diligence and reporting obligations. CRS was introduced without this exemption, meaning that charities may fall into scope.*

HMRC's recently-released guidance makes it clear that HMRC expects charities to take these new obligations seriously. It is therefore clear that impacted charities will have to put in place procedures to identify and potentially report 'account holders'.

The guidance does, however, reflect the unique position of charities. It provides clarity about who will be considered 'account holders' for both corporate and non-corporate charities, and confirms that beneficiaries of non-corporate charities will be considered 'account holders'

Charities should look to undertake an impact assessment to determine whether they are in the scope of these regulations as a priority".

Corporate and Non-Corporate Charities

A distinction has been drawn between incorporated and non-incorporated charities, who meet CRS's definition of a Financial Institution, in respect of which individuals the entity needs to perform due diligence on and potentially disclose information about (i.e. their 'account holders') and what personal information these individuals will need to disclose.

For incorporated charities, an 'account holder' has been determined to be any individual holding a debt or equity interest in the charity. In respect of non-resident account holders, incorporated charities may need to disclose the principal amount of any debt held in the entity as well as any equity interest held. Equity interests, for the purpose of the CRS, are defined as the value calculated by the Financial Institution for the purpose that requires the most frequent determination of value.

For unincorporated charities such as trusts, in addition to those holding debt or equity interests in the trust, their 'account holders' will include any settlors or beneficiaries, as well as any person exercising 'ultimate effective control' over the trust. Whilst disclosures in respect of debt are consistent with incorporated entities, most equity interests disclosed by trusts will relate to grants made to any beneficiaries. However, an equity interest is also deemed to be held by any settlor or individual who exercises ultimate effective control over the trust, with the account value for such individuals defined as the value of their interest. Where there is no arrangement entitling the person concerned to a financial interest in the charity, the deemed equity interest will have no value and the reportable account value will be nil.

Deadlines

Any charity which meets the CRS's definition of an Financial Institution is obliged to perform due diligence in respect of account holders with an account value of more than $1m, who were extant before 1 January 2016, by *31 December 2016* . For all other account holders, this deadline is extended to *31 December 2017.* Generally this information will be presented using a self-certification form, which HMRC expects to be collected as part of any grant-making process, however this information can be collected via other methods in certain circumstances. It should be noted that HMRC have emphasised the need for a full body of evidence.

Next Steps

Now the guidance is in place charities need to perform the following steps as a priority:

1. Determine whether they fall within the definition of an FI. They need to do this for every entity in the charity group (including trusts), and not just the charity itself;
2. If so, determine their account holders and classify them for CRS purposes;
3. If necessary, ensure that they are able to report as appropriate by **31 May 2017.**

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Fundraising: the new dawn

As the dust settles over the many fundraising scandals dominating news headlines in 2015 and 2016, the fundraising provisions contained in the Charities (Protection and Social Investment) Act 2016 (the Act) intended to help protect donors, charity supporters and the public from intrusive fundraising practices came into force on 1st November 2016

The changes set out in the Act amend the existing fundraising provisions contained in the Charities Act 1992 and in the Charities Act 2011 and introduce two new requirements.

The first requirement

The first requirement affects all charitable institutions, (whether or not they are registered with the Charity Commission), that work with commercial participators or professional fundraisers (as defined in section 58 Charities Act 1992) to raise funds. The Charities Act 1992 required charities and these third parties to enter into written agreements setting out prescribed information relating to the arrangements between them. However, these provisions were originally drafted from the perspective of protecting the charity from the unscrupulous practices of third parties, rather than from the perspective of protecting the public from misrepresentation or aggressive fundraising tactics, and the new legislation now addresses this by **requiring** all such agreements to specify:

1. any voluntary scheme for fundraising, or any voluntary standard of fundraising that the commercial participator or professional fundraiser (as the case may be) undertakes to be bound by for the purposes of the agreement;
2. how the commercial participator or professional fundraiser is to protect vulnerable people and other members of the public from (a) any unreasonable intrusion on a person's privacy, (b) unreasonably persistent approaches for the purpose of soliciting or otherwise procuring money or other property and (c) undue pressure to give money or other property, in the course of, or in connection with the activities to which the agreement relates; and
3. the arrangements in place to enable the charity to monitor ongoing compliance with the agreement.

Transitional arrangements

The new Fundraising Regulator established last year to investigate poor fundraising practices and to assume the role of setting fundraising standards has announced that it will be flexible until 31 March 2017 to enable charities to get to grips with the new law and to allow time for charities to make reasonable contingency arrangements to ensure compliance. However, the absence of any transitional provisions in the Act means that there is uncertainty regarding the regulator's approach to agreements in place between charitable institutions and commercial participators and professional fundraisers prior to the new rules coming into force, and whether or not there is now a need to renegotiate and amend current agreements to ensure they are compliant. Definitive guidance on this point has not been forthcoming. However, the general consensus appears to be that agreements lasting for longer than 12 months entered into prior to the 1st November should be revisited to ensure compliance.

Sanctions for non-compliance

If fundraising agreements aren't compliant with the new legal requirements, it will affect the ability of the professional fundraiser or commercial participator to enforce the terms of the agreement against the charity. The charity will be acting in breach of the Code of Fundraising Practice and the Charity Commission and the Fundraising Regulator both expect trustees to ensure that their charity's arrangements with professional fundraisers and commercial participators conform to the law. However, perhaps most importantly, the reputational damage that is likely to follow any failure to comply with the new requirements is likely to be significant for the charity, the connected party and the charity's trustees. Particularly as the media appears to be on a campaign against the sector and therefore any issues are unlikely to go unnoticed.

The Fundraising Regulator has recently published its first adjudication decision regarding the Neet Feet scandal and criticised many well-known charities for their involvement with and monitoring of Neet Feet's operations. Lessons learnt from the investigation are likely to inform an updated Code of Fundraising Practice when it is eventually reviewed by the Fundraising Regulator.

The second requirement

The second change in the Act affects charities required by law to have their accounts audited and prescribes that the Trustees' Annual Report must now include: statements about the charity's approach to fundraising; the use of and oversight of third parties such as commercial participators and professional fundraisers; information on the charity's compliance with recognised standards and schemes regulating fundraising practices; details of any complaints relating to the charity's fundraising activities or the activities of any third party fundraising on its behalf; and details of the action taken by the charity to protect vulnerable people and other members of the public from persistent approaches, intrusions on privacy and undue pressure to give.

The Charity Commission's publication, Charity Fundraising: a guide to trustee duties (CC20) has been updated to reflect the new requirements.

Data Protection

The changes above will certainly keep charities and their fundraisers on their toes until the new requirements become the 'new normal'. However, it is not the end of the story as the spotlight on fundraising and fundraising practices is not fading and the next hot topic for fundraisers and charity trustees is the urgent need for them to improve their awareness of, and compliance with both existing data protection law and the new EU Data Protection Regulation coming into force (irrespective of Brexit) in early 2018.

In December 2016, two high profile charities were found to be in breach of the Data Protection Act 1998, in connection with their use of personal data for activities for which they had not acquired the necessary explicit consent. The Information Commissioner issued the charities with significant monetary penalties prompting a joint alert issued by the Charity Commission and the Fundraising Regulator, which stated that other charities are also under investigation. Described by Stephen Dunmore, Chief Executive of the Fundraising Regulator as a "wake-up call for the whole sector", compliance with data protection law is now an urgent priority for charities and new practical guidance is expected from the Fundraising Regulator early this year.

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