# TOP IDEAS FOR ENDOWMENT AND FOUNDATION INVESTMENT COMMITTEES IN 2017

In past years, endowment and foundation (E&F) portfolios benefited from strong equity markets, and philanthropic giving more than fully recovered from the fall experienced during the financial crisis in 2008–2009. Signs that the global economy is starting to reflate and a changing political landscape will likely lead to higher volatility, and as such, committees will revisit their investment and risk management strategies and shift further into alternative sources of alpha.

Create a plan now to position your portfolio for political and monetary policy changes.

1

DISCUSS HOME COUNTRY BIAS VS. GLOBAL DIVERSIFICATION

We live in a world connected by trade, communication and risk. E&F investor portfolios have evolved as world markets have, taking on increasingly global investment profiles. However, US markets have outpaced most other asset classes since the bottom of the great recession in 2009. After such an extended period of dominance, it is perhaps natural for US investors to raise the debate of whether they should keep their globally diversified portfolio. The stakes are high, the decisions difficult.

What is the role of global stocks in a portfolio? What impacts do fundamental factors such as demographic trends and new technologies have on relative performance expectations? What does the rise in populism mean for globally diversified portfolios? What impact does a shift by global central banks from monetary to fiscal policy have on global return expectations? What tools or strategies can an E&F investor consider today to improve their global implementation? Should the US/non-US allocation be made with an eye toward global market weights or peer behavior?

## 2

## ASSESS HEDGE FUNDS

E&Fs are among the largest users of hedge funds, embracing a wide variety of strategies in pursuit of stronger returns and/or to manage portfolio risk. Unfortunately, in the face of very strong equity markets in the past seven years, a lot of hedge fund strategies haven't generated the results that many E&Fs were expecting. A number of high-profile investors are reducing or eliminating their exposure. Now is a good time to revisit your hedge fund portfolio and confirm the role and expectations for hedge funds.

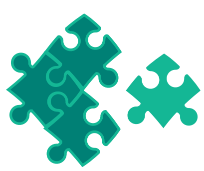
Do you use hedge funds for offense or defense, and how does that affect your evaluation of success? What impact should your spending rate and the nature of your underlying charitable commitments have on your allocation and strategy-specific implementation decisions? What opportunities exist in hedge funds today that might add value to your portfolio? With over $2 trillion invested in hedge funds globally, what is the true potential for alpha going forward? As investors grapple with the need for alpha in what is expected to be a low-return environment, we believe it is important to look forward, not backward, in recognizing the benefits that hedge funds may be able to bring to a portfolio relative to traditional strategies.

## 3

## FOCUS ON BENCHMARKING

As a basis for evaluation, what informational value do investment committees derive from benchmarking? Benchmarks should reflect the ultimate risk/return posture of the organization. The benchmark provides a means to evaluate the success of the investment program and assess the value of periodic movement around the policy target. Are benchmarks designed as a target to achieve or exceed? What if your portfolio is achieving or exceeding your customized benchmark but underperforming on the long-term return goal or peer universe? Is there consensus on the proper benchmarks to use and the relative ranking of them, given that they change over time as the environment and committee change?

The idea of benchmarking your portfolio may initially appear simple. It is not. Too often, benchmarks are used in a simple binary measure of success and failure, and that measurement leads to discussions and potential changes in tactical and strategic investment policy — and in certain situations, no changes, which can be equally concerning. In reality, investment committees should dedicate a significant amount of time to designing a customized policy benchmark that captures not only its return needs but also the quantitative and qualitative risk factors. The more challenging aspect that E&F committees are faced with is how they interpret, communicate and act on various levels of performance relative to their benchmark(s). How can committees create a framework and monitoring process to ensure that benchmarking is given the time and attention it deserves?



Benchmarks should reflect the ultimate risk/return posture of the organization.

## 4

## EVALUATE LIQUIDITY REQUIREMENTS AND THE TRADE-OFF IN REDUCING LIQUIDITY

In general, we believe perpetual E&F investors pay too dear a price to maintain liquidity — that is, the ability to quickly sell investments in a portfolio either to generate cash for specific needs or to maintain "flexibility" that might never be used. Using NACUBO as a guide, many E&F investors with assets under $500 million maintain more than half of their portfolios in daily traded public securities. These organizations typically draw only 5% or less per year from their investment pool and are generally not overly tactical — suggesting that they have the capacity to increase access to illiquidity premiums. For very-long-horizon investors such as E&Fs, private equity, private debt or private real estate may increase potential long-term returns, much more so than through tactical portfolio adjustments.

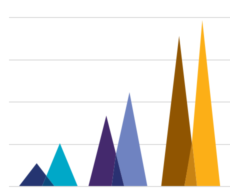
What institutional drivers support specific levels of liquidity, and how are those balanced against organizational attitudes or biases toward liquidity? How should a committee consider its liquidity budget, and what steps are necessary to enhance committee and staff views around the liquidity goals of the organization.

## 5

## CONSIDER PRIVATE DEBT ASSETS

With low interest rates and fully valued equity markets, E&F investors must work hard to find opportunities to generate returns that meet long-term growth and spending needs. Private debt offers flexibility and a connection to the real economy. Since the global financial crisis, the visibility of middle market private debt has grown substantially. The private debt market creates a unique intersection between the needs of small- and midmarket borrowers, and the yield- and return-seeking of E&F investors.

What risks do investors consider with a private debt investment, and what is the payoff? How can private debt generate returns to support long-term growth while also providing liquidity to meet short- and intermediate-term cash flow needs? Where does private debt fit into the asset allocation strategy for an E&F? E&F investors have flexibility to use a portion of their liquidity budget to increase the income return and enhance the long-term return potential of their portfolio with modest risk exposure.



E&F investors can tailor their return and risk exposures to meet their specific objectives.

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## EMBRACE TRULY ACTIVE STRATEGIES TO ENHANCE RETURNS

Over the past several years, accommodative Federal Reserve policy has provided a large wind to the market's sails, driving returns for many investors through the market, or beta, allocation in their portfolios. Accessing beta through a passive approach is a reasonable strategy in this type of environment, paying a low cost to benefit from an otherwise upward trend.

We believe those market winds are beginning to change. The Fed seems prepared to roll back the easy money stance. We believe E&F investors should reposition their portfolios to derive more return potential from active management impact, or alpha. E&F investors should use their long time horizons to optimize their active management risk budget. This is best achieved with an increasing focus on return drivers such as concentration or activism, and on manager characteristics such as broader global mandates, niche differentiated strategies and opportunistic approaches.

How should E&F investors adjust their views on risk to take better advantage of active strategies? What role does passive investing play alongside increasing the active management risk budget? Should E&F investors focus active management in specific areas while maintaining passive allocations in others? How should E&F investors consider their fee budget relative to the return potential of greater alpha? With less return available from simple beta, E&F investors will benefit from boosting their active risk budget.

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## ANALYZE WHETHER ESG INVESTING CAN IMPROVE BOTH RETURNS AND RESPONSIBLE INVESTMENT OBJECTIVES

Environmental, social and governance, or ESG-driven investing, is growing in concept and awareness across the globe. US investors, including most E&Fs, have been slow to embrace ESG as an implementation approach, even if they agree in principle with the basics behind it. To further the ESG conversation, we believe E&F investors can advance their exploration of the concept by addressing it from a different angle — one of global scarcity and changing demand patterns — that may provide strong opportunities for long-term return and responsible investment enhancement for E&F portfolios.

The United Nations expects world population to grow from the roughly 7 billion people today to over 9.5 billion by 2050. Most of those people will want clean water and many will desire Western diets and lifestyles. This population growth will put significant pressure on global resources and create investment opportunities for long-term-oriented investors like E&Fs.

How can E&F investors use their very long horizons to optimize specific ESG-related strategies such as water? How do E&F investors appropriately consider the potential short-term risks associated with specialized investments? Can other dedicated areas like healthcare meet both long-term return expectations and a more general view of ESG through a global scarcity lens?

We believe the concepts behind ESG will lead to better return potential over time, while also meeting many of the responsible investing objectives. Climate change will become over time another consistent element of risk in an investment portfolio. Specialist allocations may be the optimal first step for E&F investors to seek improvement in their double bottom line.

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## EVALUATE THE ENDOWMENT MODEL

Some have argued that the past several years spell the end of the "endowment model," particularly for smaller E&Fs. We disagree. The objective of the endowment model is to generate long-term returns that can maintain the real value of spending and to do so in a way that balances volatility with the long-term growth need.

The endowment model is characterized by heavier allocations to longer-term growth-oriented investments like stocks and private equity, lesser allocations to traditional fixed income, greater acceptance of illiquidity, and considerable reliance on active manager selection to derive excess returns over time. Will private equity continue to provide a premium to public markets? Can active strategies such as hedge funds demonstrate value-add going forward? What is the ultimate impact to E&F portfolios of the significant movement toward passive investing? It may be difficult for many E&F investors to maintain their commitment to the endowment model. After such a strong run for US large-cap stocks, we think the bigger risk may be to abandon the long-term focus of the endowment model.

Private equity, private debt or private real estate may increase potential long-term returns.

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## REVIEW THE ROLE AND IMPORTANCE OF GIFTS TO AN ENDOWMENT OVER THE LONG TERM

Most E&F's real purchasing power comes from balancing the inputs of their spending rule and expected return along with the third key area to consider — gifts. Gifts may be the difference between decline and real growth in a low-return environment. As a critical factor in the equation, do E&Fs spend enough time contemplating the long-term impact of gifts on the endowment? Do they involve the development office in quarterly meetings so they can get to know "the story" firsthand? Does the investment/finance committee provide enough input to the board to demonstrate the importance of gifts for long-term success? Would greater gift inflows provide more flexibility for organizations to increase the long-term focus of their portfolios?

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### IMPLEMENT BEST GOVERNANCE PRACTICES

Sound governance practices are success factors for improving investment returns, board operations, fundraising, reputation and recruitment. They're the business side of E&Fs, and are critical to running your board successfully. Review key strategic areas of investment committee operations and ask the following questions: Do we have best practices in place to define governance roles and responsibilities? Are the protocols and communication guidelines effective or just routine? Flexibility is important in a dynamic market environment. Are the investment processes and program flexible enough to act appropriately?

Sound governance practices are critical to running your board successfully.

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