TOP INVESTMENT PRIORITIES FOR ENDOWMENTS AND FOUNDATIONS IN 2019

Equity market volatility, high public equity valuations, tight credit spreads and rising interest rates have led institutional investors to reevaluate investment portfolios. Mercer has detailed key areas of consideration as endowment and foundation (E&F) clients navigate the current market landscape.

RISING RATES AND THE END OF A CYCLE: EXAMINE OVERALL CREDIT EXPOSURE

Credit from across the quality spectrum has become a regular fixture in E&F portfolios. The popularity of adding credit strategies has reduced the opportunity, and spread narrowing, higher relative debt levels, rising interest rates and the potential end to the business cycle all suggest caution related to credit positions. If credit has replaced more traditional fixed income in your allocation, consider a fresh asset allocation study to ensure that you have the appropriate downside protection and liquidity available in the event of a credit or equity pullback. Review your liquidity terms and consider alternative plans to meet liquidity requirements. Evaluate your regional exposures — opportunities in Europe are finally emerging via bank divestitures similar to US bank activity shortly after the global financial crisis. Understand how your position is leveraged at the fund level and at the underlying business level. Credit can remain a strong ally to your portfolio, but it is time to ensure that the allocation is appropriate.

HELLO, INFLATION, MY OLD FRIEND

Late-cycle stimulus has helped push the US unemployment rate to generational lows, and Australian unemployment rate to a seven year low, and wages are finally beginning to respond. Fully protecting a portfolio against spikes in inflation is difficult, but it is important to review your allocation mix to understand the shorter and longer term expectations around performance during times of inflation. Many developed economies haven't experienced meaningful inflation in over a generation, but E&Fs have lived in a greater inflationary environment for many years. A fresh look at your asset allocation can improve your odds of meeting your objectives.

CLOUDY WITH A CHANCE OF DISAPPOINTING RETURNS

We are in the 10th year of global economic and market expansion. The era of low/zero interest rates appears to be over, and assets across the risk spectrum are fully priced. Even if we avoid a meaningful correction or crisis across the globe, asset prices today suggest modest returns going forward for most asset classes, creating difficult choices for E&Fs seeking to meet the near and longer term funding needs for their organizations. Consider your asset allocation and discuss the risk/return trade-off of potential opportunities. Evaluate your spending model and the impact of lower potential returns and also the greater year-to-year volatility of those returns. The relative return of cash is possibly more attractive today than at many times in the recent past versus both stocks and bonds. Consider building a strategic position for cash to facilitate distributions in the event of market turbulence.

ALPHA AFTER A TIME OF BETA

Passive investing has dominated market returns for the past decade. Increasingly, E&F investors are shifting allocations into low-cost, capweighted index strategies that seek to match market returns. But for non-profit investors, is this the right strategy as we near the potential end of a long stock market and economic cycle? As interest rates rise and growth slows, the value of active management should increase in importance and success. Evaluate areas of potential active value, the ability of managers to add value against benchmarks is cyclical. If the cycle turns, consider which areas might be best positioned to benefit from a more active-friendly environment.

WHAT TO DO WHEN YOU ARE EXPECTING VOLATILITY

Investors' ability to remain focused on the long term has not been tested recently. Modest pullbacks in 2011 and 2015 did little to shake investors' confidence in their long-term exposures. Late 2018 activity reminded E&Fs that volatility still existed, even if it had been well off the main stage. Investors should consider stress-testing portfolios against multiple scenarios. Did the December quarter performance fit within your expectations? What actions should you consider relative to your long-term plan? Rebalance now or wait? Methodically working through your emergency plan can help you remain focused on the long term and give you the confidence to take advantage of market opportunities while others wait on the sidelines.

WHEN IS NICHE, NICHE?

E&F investors often seek the less-traveled path, demonstrating the capacity and appetite to consider strategies and managers that are less well-known, less well capitalized and less experienced. For many, this path has produced strong long-term results in support of the organizational mission. Niche does not guarantee great returns, and starting with a core position in high-conviction managers is always a great place from which to add more interesting and perhaps lucrative allocations. Add a blue-sky session to your early 2019 calendar and, as a committee, consider unique areas of long- or shorter-term opportunities. Ideas could be manager-specific or thematic — for example, does the global growth in population, increasing occurrence of severe climate events and substantial pollution create an opportunity to focus on strategies that support the security and delivery of clean water?

CONSIDERING THE LIQUIDITY PREMIUM WHEN LIQUIDITY DRIES UP

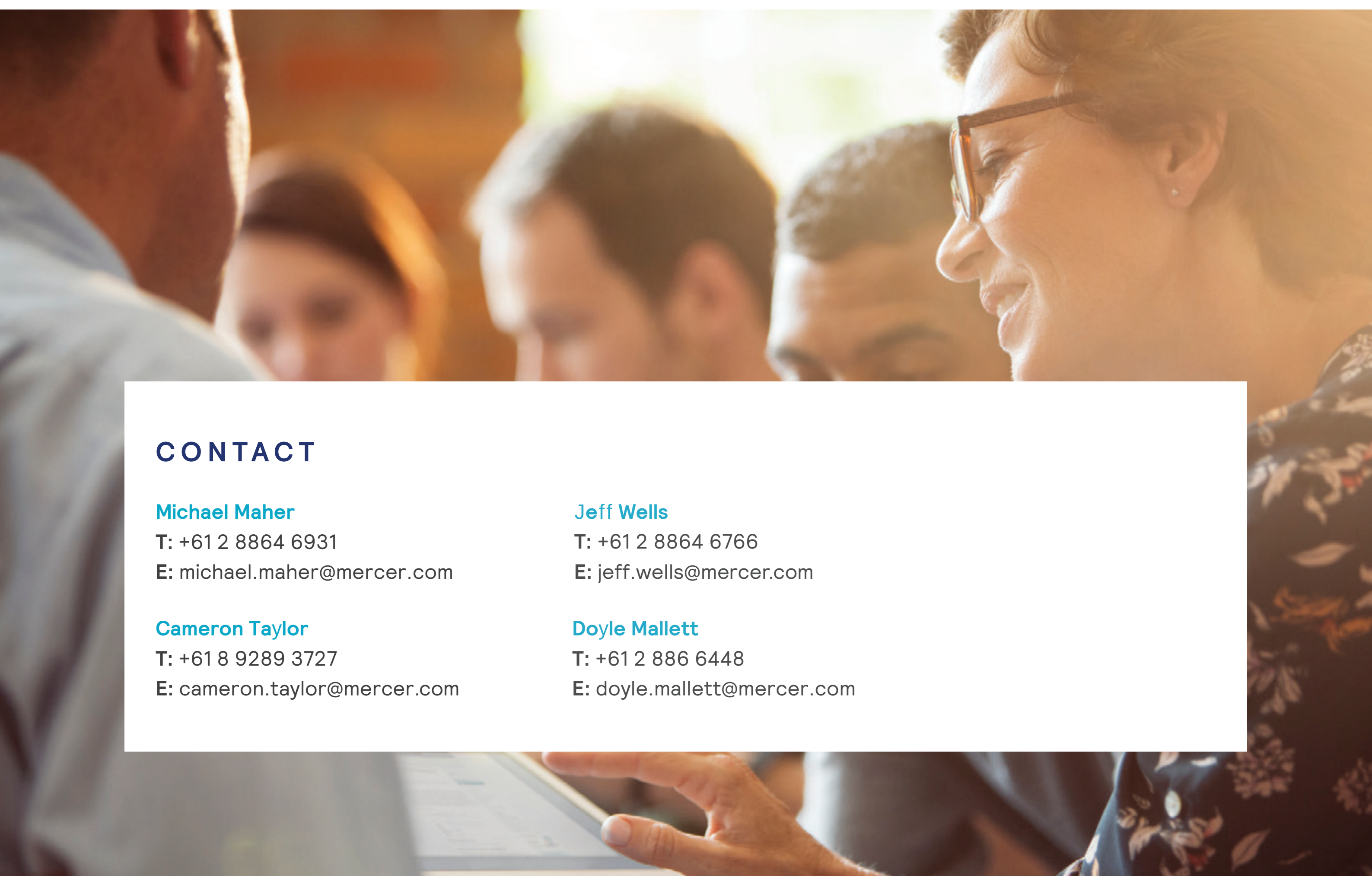
Private equity investors have experienced reduced expectations for excess return versus public markets as more capital has entered private equity. E&F investors, long supporters of private equity, should consider the impacts of the change in market cycle and the reduction of liquidity in markets when evaluating private-capital commitments. Assess your liquidity budget in the context of meeting current obligations and of your ability to take advantage of opportunities. Will distressed equity present an opportunity, and how should investors react? Contingent fund structures might provide some attractiveness, holding down fees while setting aside capital to address an opportunity when it arises. Acting as providers of liquidity may also represent opportunity for E&F portfolios. Secondary private-equity deals are pretty fully priced today, but in a crisis, it becomes a buyers' market. Evaluate how effective your portfolio can be as a provider of liquidity. In a severe correction, will you have the liquidity to support institutional spending, unfunded private investment commitments and dynamic rebalancing opportunities, as well as any collateral requirements or liabilities that could arise from the market disruption? Are you comfortable that the required liquidity will be available from your assets? Markets rebounded fairly quickly in 2009. Would you be in a position to weather a more prolonged drawdown? Review your liquidity budget — we believe the liquidity premium is alive and well, or at least will be when things get rough.

CHINA … IT'S NOT JUST FOR EMERGING MARKETS ANYMORE

Chinese stock markets have moved to center stage. As an E&F investor, it's important to understand your China exposure and to ensure that it fits your risk/return profile. The growth of China and, perhaps more important, its efforts at market liberalization, raise some practical questions for investors about how to manage their exposure to the world's second-largest economy. With the addition of a wider allocation of Chinese stocks in global indexes, the prospect of considering a dedicated China allocation alongside an ex-China emerging markets allocation grows. Should you consider a dedicated allocation, and if so, what arguments can be made for an active allocation versus a passive allocation? As a passive investor, your emerging markets allocation is nearing 40% China. What impact does that have on overall risk/return expectations? The growing prevalence of the markets on the world stage means E&F committees have to take a considered approach to balance the risks associated with investing in China with the growth opportunity that the country still clearly presents.

IS ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) COMING TO A PORTFOLIO NEAR YOU?

ESG-driven investing continues to take greater prominence globally. How should your committee evaluate ESG, and how can you grow confidence that a portfolio that integrates ESG characteristics can deliver the returns needed to support the organization? Start with a conversation about what ESG might mean to you. How would your organization and committee define the important notions that drive your organization or that should inform your investment decisions? These considerations can grow from any angle and may not even register the feel-good sensation historically associated with ESG; for example, if your committee believes lower carbon rules are on the horizon, how should your committee consider energy investments going forward?



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