NAVIGATING THE ENDOWMENT AND FOUNDATION LANDSCAPE IN 2018

Last year, Highland identified 10 critical areas that we believed Endowment and Foundation (E&F) investors should reevaluate, given the market backdrop, proposed tax reform, and potential impact on charitable deductions. The 2017 Tax Cuts and Jobs Act was signed into law on December 22, and organizations are beginning to brace for the impact to their bottom line in the coming year. On a positive note, another robust year for investment markets (especially equities) helped to sustain and, for some, increase spending rates. As we move further into 2018, Highland Associates highlights 10 areas for discussion.

Highland's goal is to ensure that the investment portfolio reflects the needs of the organization as a whole. For foundations and endowments, Highland understands the interdependence of spending policy, investment policy, and mission. Specifically, we know how important it is for all of the pieces to work together to fund the needs of today as well as tomorrow.

1. REASSESS INVESTMENT PORTFOLIOS AMID AN UNCERTAIN OPERATING AND FINANCIAL BACKDROP.

Most endowments and foundations will likely face another year of operational pressures in 2018. Endowments are facing increasing discount rates, higher cost, and lower revenue pressures, while foundations and endowments will confront the new tax code and its impact on giving. These pressures are coming at a time of recent strong portfolio performance and elevated markets. Should markets sell off or correct, the combined forces will stress the operational environment to a great extent. The decision of whether to increase or decrease the risk profile of the investment portfolio is unique to each organization and requires a dynamic view of the portfolio's role and how it relates to the organization and its mission. A clear understanding of the impact portfolio decisions may have on the financial health of each organization is paramount.

2. STUDY THE IMPACT OF TAX REFORM ON GIVING.

The 2017 Tax Cuts and Jobs Act will have an impact on organizational giving in 2018. According to the Council on Foundations, charitable contributions will be reduced between $13 billion to $24 billion a year due to the increase in the standard deduction. This most likely will impact smaller donations across all organizations as the incentive to donate is reduced. How this reduction impacts an organization depends on the donor mix, but regardless, organizations should expect top line income to be affected.

3. EVALUATE YOUR ORGANIZATION'S SPENDING POLICY.

A foundation's spending policy serves as the vital link between portfolio and mission. A well-designed policy seeks to provide continued support while preserving the long-term value of the assets. Characteristics of a good spending policy include the following: 1) reliability—it should grow with the foundation's needs, and 2) sustainability—avoid overspending in extreme markets. Given the operational and funding challenges facing organizations in 2018, it is prudent to review the spending policy, understand the current methodology, and then stress test the spending contribution given funding and potential market impacts.

4. FOCUS ON THE FUNDAMENTALS. BEWARE OF FOMO.

As equity prices around the world continue to reach new heights, some investors are wondering why they should invest in anything other than stocks. This is a perfectly natural emotional response and a perfectly predictable one, as well. However, decades (if not centuries) of market data tell us that these emotional biases work against us far more than they work for us. In "More Than a Feeling: Why Diversification Still Matters," we examine the sources of investors' emotional decision-making and advocate instead for an objective, data-driven framework that prioritizes diversification.

5. DEVELOP A NEW PERSPECTIVE ON PRIVATE INVESTMENTS.

Alternatives can offer hope in a low-return environment, but as assets flow into private investments, return expectation should decrease. Evaluation of private (or opportunistic) investments requires an approach different from that of traditional investments. In "Private Equity Investments: What You See Is Not Always What You Get," we discuss how existing measurement tools such as Internal Rate of Return (IRR) or Multiple of Capital(x) do not translate effectively from private to public markets, as neither measures how long it takes for the return to be generated. This may lead to the wrong conclusion when evaluating the opportunity costs of such investments. Utilizing a Time-Weighted Equivalent (TWE) calculation can provide an apples to apples comparison of private versus public investments. As private investments should command a return premium over public markets, a 10% TWE is Highland's threshold for investment. Due to the sizable amount of capital flowing into larger mainstream private deals, a niche focus with an emphasis on smaller deals will likely be necessary to generate the 10% TWE hurdle.

6. VIEW THE WORLD IN 3-D.

We believe we are approaching a turning point in how investors allocate capital going forward. It will be important to dig through broad markets to find value, as certain areas of the market will benefit more than others. With newly enacted tax reform, some of the more capital-intensive companies stand to gain the most from lower taxes. On the other hand, highly indebted companies will be hurt by a lower tax benefit from expensing debt and higher funding costs from increasing LIBOR. As we move further into the business cycle, investors will be more discerning toward company balance sheets and how management apportions capital. By conducting our own analysis and looking at the fundamentals to understand the true drivers, we can recognize what is going to drive the market moving forward. This attitude drives our **3-D** approach to **Decode** and **Deconstruct** to **Deliver Value**. Investors must dissect broad markets and find these opportunities to achieve the returns needed to meet their objectives.

7. DEFINED CONTRIBUTION—EDUCATION AND FINANCIAL WELLNESS ARE TAKING CENTER STAGE.

Plan fees for defined contribution plans have been a hot topic for several years. The focus on fees drove plan sponsors to review and lower expenses to a point where expenses are now starting to stabilize. With overall fees beginning to moderate, plan sponsors should now focus their time on understanding their plan participants' needs. This needs-based approach allows plan sponsors to deliver more effective solutions. These may include targeted participant education, financial wellness programs, or potentially adding voluntary benefits such as critical illness or life insurance policies, identity theft protection, or even short-term disability. This shift is important for plan sponsors, as many participants want employers to take a more active role in ensuring employees' financial wellness.

8. UNDERSTAND YOUR PARTNERS' COMMITMENT TO EQUITY.

"Equity" is defined as the quality of being fair and impartial. For many organizations, this concept is core to their operation and mission. Specifically, foundations and endowments are asking their investment partner organizations if they are committed to equity, and they are questioning how minorities and women are included in their firms and at what levels. How can Highland help? We have experience talking to service providers about such issues. We can include language in client searches that addresses firm diversity and gain a better understanding of whether equity is a part of firm culture.

9. EVALUATE THE UBIQUITY OF ESG.

Similar to the way investors are researching their partner organizations' commitment to equity, many are also implementing ESG criteria into their decision-making frameworks. For E&F investors, ESG can help to better align investment portfolios with their core mission. What began years ago as simple exclusions of sin stocks (negative screening) has evolved into a critical aspect of active portfolio management, including advocacy and portfolio construction. In an upcoming *Insight*, we will discuss how money managers are using ESG factors to augment their fundamental research and investment process.

10. CONTINUE TO FOCUS ON GOVERNANCE.

Governance establishes the policies and process to guide execution of an investment program. Successful policies ensure that everyone is on the same page regarding mission and that the objectives and responsibilities for all committees, staff, and adviser are well documented. Governance creates policy interdependence incorporating spending, mission, and investing. All too often, investment policies fail to link assets to mission and thus the portfolio is not fully integrated into the organization. This lack of alignment can lead to unrealistic objectives and a sub-optimal investment program. In 2017, E&F organizations continued on the path of improving or evaluating current investment policies. Key items in a successful policy include 1) investment objective, 2) roles and responsibilities of interested parties, 3) performance expectations, 4) spending needs, and 5) prohibition on investments.