NAVIGATING THE ENDOWMENT & FOUNDATION LANDSCAPE IN 2017

As many endowments and foundations (E&F) come to grips with muted returns for traditional markets, the standard 60% equities and 40% fixed income balanced portfolio coupled with a 5% spending rate may no longer be sustainable. A challenging investment environment coupled with comprehensive tax reform and potential impact on charitable deductions signals a time for E&Fs to pause and assess their current position. As we move further into 2017, 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. ALIGN INVESTMENT PORTFOLIOS TO MEET THE OBJECTIVES OF THE ORGANIZATION.

E&Fs should memorialize the long-term objective of the organization and detail the steps to achieve the end result. Part of that exercise includes matching the money to the specific mission. One size does not fit all organizations. Each group has different philosophies, risk, time horizon, and life cycle. Acknowledging these institutional-specific objectives will ultimately drive the asset allocation decision. Defining your investment approach independent of peer group comparisons will determine whether your portfolio was successfully aligned to meet the organization's mission.

2. VIEW THE WORLD IN 3-D.

Capital markets are increasingly being driven by geopolitical fears. Brexit and the rise of populist movements across the globe are just some of the recent events that are shaping capital markets. In this environment, simply investing in broad geographic markets will not work. Investors searching for returns must look at the world's opportunity set in 3-D: Decode and Deconstruct to Deliver value. In "***Capital Markets Quarterly 4Q16: The World in 3-D***" we discussed how investors can take a more micro view, allowing them to avoid the areas with higher downside risk and commit capital to the ones that should benefit from this new era of nationalism and populism.

3. REVISIT INFLATION-SENSITIVE ASSETS.

Inflationary pressures have been building, and several measures are at their highest levels since 2012. In "***Inflation: The Silent Threat***" we discussed how E&Fs must contend with inflation. E&Fs also have to grapple with inflation and its impact on portfolios. The goal is to increase the value of their portfolio to cover a spending rate plus pay administrative expenses. Many institutions use inflation as a factor in determining their yearly spending rate. This makes protecting their purchasing power a major focus. Unfortunately, many E&Fs remain underallocated to inflation-sensitive assets, making them ill-prepared to handle increases in inflation.

4. STAY THE COURSE WITH HEDGE FUNDS.

Many investors are questioning the benefit of allocating money to hedge funds after recent bouts of underperformance along with well-publicized outflows. In our view, the industry has suffered in two ways: (1) It became crowded with too many managers following similar strategies, and (2) funds have sacrificed too much of the upside in order to protect on the downside that never materialized post 2009. With that said, we believe hedge funds remain an important strategy, particularly for foundation clients who balance the needs of today (current spending) with the needs of tomorrow (perpetual growth of assets). Highland's approach to hedged equity is to deliver sustainable alpha through multiple sources. First, we pursue "structural alpha" through portfolio construction. Secondly, we target "manager alpha" by finding skilled managers that can generate returns in all kinds of market environments. We recently discussed Highland's approach to hedged equity in "***Conformists, Rebels, and Realists: Are Hedge Funds Still Viable?***"

5. ACTIVE AND PASSIVE STRATEGIES CAN COEXIST IN A PORTFOLIO.

The active versus passive debate continues to rage, as 2016 was another difficult year for active stock pickers. While Highland prefers active management, we do understand that some areas of the market are more efficient than others and may call for passive implementation. We believe emotional capital is better spent investing in areas of the market that are more inefficient and lend themselves to active management. Highland believes that considering active or passive strategies does not have to be an "either/or" approach.

6. GLOBAL INVESTING—LOOK BEYOND YOUR BORDERS.

U.S. equities have materially outperformed international developed and emerging stock markets following the Global Financial Crisis, leaving many to question the benefits of allocating capital outside of the U.S. Recent returns notwithstanding, there are several compelling reasons to maintain meaningful international equity exposure. **Qualitatively**, foreign markets have begun to close the gap in terms of innovation, corporate governance, and transparency, although work remains to be done. **Quantitatively**, the recent spike in volatility and correlations in non-U.S. stocks could fade as worldwide central bank policies become less coordinated. If this is the case, the diversification benefits provided by international stocks should once again become readily apparent. **Fundamentally**, non-U.S. equities—and emerging market stocks especially—trade at much more attractive valuations than their U.S. counterparts, which should eventually (though not necessarily immediately) set the stage for a relative performance recovery. Higher growth potential and favorable demographics in emerging markets also support the case for investing outside of our borders.

7. EVALUATE YOUR 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 a foundation's needs, and (2) sustainability—avoid overspending in extreme markets. As we move into 2017, Highland Associates forecasts that future returns will be below their historical norms given the current valuations across the markets and low yields within fixed income. Based on Highland's current forward-looking assumptions, a balanced portfolio consisting of 60% S&P 500/40% Barclays Aggregate will return 3.75% over the next 10 years versus the 7.0% it would have returned over the past 20 years. Therefore, maintaining a 5% or higher spending policy with a balanced allocation will be difficult going forward. It is important for foundations to evaluate their payout level and look to include allocations to other asset classes to help the portfolio meet its long-term objective.

8. UNDERSTAND THE IMPACT OF COMPREHENSIVE TAX REFORM AND ITS IMPACT ON CHARITABLE TAX DEDUCTIONS.

As the President and Congress tackle comprehensive tax reform, the status of charitable tax deductions is front and center for all nonprofit organizations. Charities are readying to lobby against tax reform legislation in Congress that could severely stifle giving and cut the number of Americans who can claim the charitable tax deduction by 80% to just one out of 20 taxpayers. Rumblings coming from President Donald Trump's tax plan and the House Republican Blueprint suggest charities face two big hurdles: reduced income tax incentives for charitable giving and estate tax repeal. While tax reform appears to have taken a backseat to healthcare "repeal and replace legislation," it is still a hot topic for 2017.

9. EVALUATE OUTSOURCING.

Asset growth of the outsourced chief investment officer model (OCIO) has grown significantly (14%) since 2012. Volunteer boards have not been able to manage the increasing complexity and high demands of the market. Staff have been unable to put the time and resources toward doing all the work that OCIOs do. The two main benefits of outsourcing include the following: (1) It creates more efficient use of time—foundations can focus on meeting the mission while OCIO focuses on hire/fire manager decisions—and (2) lowered costs are created by aggregating assets and negotiating fees. As E&Fs evaluate their current investment programs, OCIO may be worth further analysis.

10. EVALUATE GOVERNANCE POLICIES.

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 advisor 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.

SOURCES

Wellington Capital Management and Forbes.