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2020 vision

endowments and foundations

Top 10 investment priorities

welcome to brighter

Investors start this new decade with rich equity valuations and global debt levels at record highs, requiring a thoughtful reevaluation of portfolio positioning for the next decade. Pavilion[1] has identified top investment ideas across four themes for endowment and foundation (E&F) clients to consider in preparation for the next decade.

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[1] Services to be provided by Mercer Investments LLC, using the business name of Pavilion, a Mercer Practice ("Pavilion"), which is one of several associated legal entities that provide investments services to clients as part of a global investment advisory and investment management business (collectively referred to as "Mercer").

Institutional investors have a lot to consider not just for this year, but for the next decade. Pavilion's top investment ideas for E&F clients in 2020 fall into four themes: Protect, Reflect, Capitalize and Organize. The order of these four themes is intentional, with a particular emphasis on prudent portfolio protection given market conditions.

Protect

- Bolster portfolio resiliency
- Diversify defense
- Lock down liquidity

Reflect

- Examine the portfolio's holistic context
- Explore all facets of the spending policy

Capitalize

- Consider converging markets
- Revisit the illiquidity premium
- Reassess real assets

Organize

- Build governance resiliency
- Engage in the diversity and inclusion conversation

Protect

01/

Bolster portfolio resiliency

Markets always involve uncertainty, with risks lurking around every economic data point, earnings release or news story. Markets are also cyclical — and while no two cycles are ever identical, a variety of risks rise and fall as each cycle progresses. Global political risks seem especially acute in 2020, adding even more uncertainty to the late-cycle dynamics at play across the global economy.

- **Action: Assess the potential risks of the late cycle and potential volatility sparked by critical elections around the world, and consider the degree of resiliency built into your portfolio.**

02/

Diversify defense

High-quality fixed income has traditionally been a helpful defensive asset, providing not just some protection in equity market drawdowns, but yields that have meaningfully exceeded inflation. Government bond yields may be low for quite some time, providing long-term investors with expected returns that may just keep pace with inflation and, with certainty, not meet many endowment and foundation distribution rates.

- **Action: Consider other "low beta" strategies to diversify the defensive part of your portfolio that may offer higher expected returns than bond yields.**

03/

Lock down liquidity

Many trustees of long-term endowment and foundation portfolios focus on managing the "risk" side of the portfolio — where to earn enough in returns to maintain and grow intergenerational equity. Risk-taking is easier and involves greater confidence when short-term liquidity needs are certain.

- **Action: Review the portfolio's liquidity reserves and needs. Ensure that cash reserves are earning appropriate high-quality money market rates, while remaining focused on government securities that provide the highest degree of liquidity in times of market stress.**

Reflect

04/

Examine the portfolio's holistic context

An investment portfolio can be a strategic asset on an institution's balance sheet. What strategic role does it play for the organization? Does it provide regular liquidity? Do the organization and its grantees have a particular dependence on regular distributions from the portfolio? Does the portfolio provide a strategic advantage over the institution's competitors? Is the portfolio's risk calibrated appropriately for the organization? Answers to these questions are particularly critical in a lower rate, higher volatility capital markets environment.

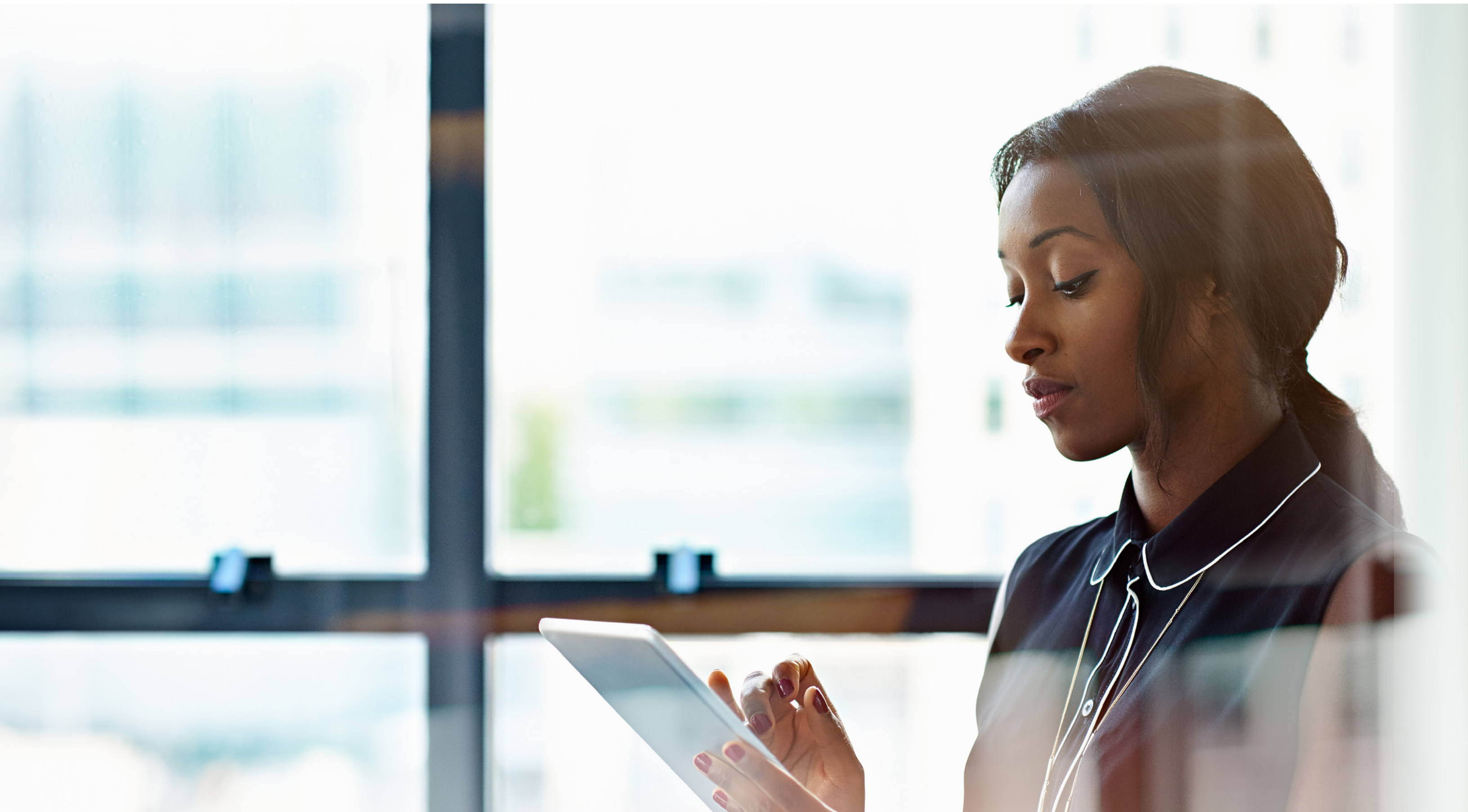
- **Action: Review the role of the investment portfolio in the overall organization to ensure that its characteristics align with that role.**

05/

Explore all facets of the spending policy

Distributions are how the portfolio provides for the mission of the broader organization. Balancing today's needs against preserving value for future generations is at the heart of many discussions over the past few years on the spending policy rate, but other aspects of spending policy merit review: the smoothing ("lookback") period, measurement frequency and mechanics of accruing or distributing funds all play crucial roles in times of market stress.

- **Action: Review not just the institution's spending policy distribution rate, but also the methodology and all operational aspects around distributions to best meet the organization's mission objectives.**



Capitalize

06/

Consider converging markets

The public and private investment worlds have been converging. Private debt is filling in the role that banks used to play in capital markets. Growth private equity is allowing companies to stay private for longer, even as the number of publicly traded US stocks has fallen. Listed infrastructure companies are providing public markets investors with access to historically private investment opportunities. All of these markets will continue to evolve.

- **Action: Assess the whole universe of public and private investments, and the liquidity profile of the portfolio's investments, to access opportunities across the illiquidity spectrum.**

07/

Revisit the illiquidity premium

The ongoing convergence of public and private markets will likely put a dent in what has been a healthy illiquidity premium historically. The premium is only theoretical, and it is only known with certainty after a private capital fund's life is over, which may take a decade or longer. Conviction in the illiquidity premium is key to maintaining a disciplined approach to investing in private markets, even as that illiquidity premium may be declining.

- **Action: Consider ways in which the wide variety of private market investments should be accessed in the portfolio. Review the illiquid strategies being used to reconfirm confidence in the degree of illiquidity premium that is expected from those strategies.**

08/

Reassess real assets

The universe of real assets investments is quite heterogeneous — a wide variety of inflation-sensitive assets have equity and bond market sensitivities, volatilities and expected returns. Some are income-oriented, others provide growth, and still others are part of the traditional universe of stocks and bonds. In a time of relatively low expected inflation, real assets may be a challenging place to remain invested, but they also provide some opportunities for diversification.

- **Action: Reaffirm the role of real assets in the portfolio — inflation hedge, regular income or an equity diversifier — and ensure that the portfolio's exposure is aligned with that role.**

Organize

09/

Build governance resiliency

Endowments and foundations are typically blessed to be governed by boards and committees of highly dedicated volunteers. As volunteers, however, their time is precious, and their terms may even be limited by an organization's by-laws. Changes in markets that lead to necessary action, or changes in the composition of committees, can lead to swings in investment implementation of what should be a disciplined long-term portfolio strategy.

- **Action: Codify the institution's investment beliefs and align processes with those beliefs to help weather turnover.**

10/

Engage in the diversity and inclusion conversation

The "G" in "ESG" strategies (environment, social and governance) often gets short shrift. A potential value in the investment governance structure is diversity and inclusion within an organization, as well as among the investment managers of a portfolio. Mission-driven endowments and foundations are uniquely positioned to lead the ongoing global conversation around diversity and inclusion.

- **Action: Consider how your institution incorporates and advocates for diversity and inclusion in the investment decision-making process.**

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