THE THREE PILLARS OF A SUCCESSFUL INVESTMENT PLAN FOR ENDOWMENTS AND FOUNDATIONS

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NEPC's Endowments and Foundations Team

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Coming off a bountiful year and decade, endowments and foundations are looking to lay the groundwork for the next 10 years. As of late, concerns have mounted around the impact of robust markets on expanding operating budgets, and organizations are trying to understand how to position themselves so that the continued success of their investment programs provides them with the resources and flexibility they need to accomplish their mission and goals.

But 2019 is going to be a tough year to top: the S&P 500—the largest holding in most investment portfolios—was up 31.5% in 2019, as it hit one high after another, bolstered by an accommodative monetary policy and a thaw in the trade relations between the United States and China. Adding to this impressive string of wins: the US economy completed a calendar decade without a recession—a historical first. While investors are keen to replicate these successes, it is unlikely this period of windfall gains and low market volatility will persist for the next decade, especially in this late phase of the economic cycle. To this end, it is more important than ever for investors to place a renewed emphasis on strategic asset allocation and understanding their risk tolerance to ensure their investment horizon and governance structure are aligned with their mission and return objectives.

Although each endowment and foundation is unique in its goals, philosophy, construction and investment approach, they all share the same three pillars of a successful investment plan: mission fulfillment, governance and investment management. In this paper, we discuss each of these pillars and the role NEPC can play in helping our clients think through these issues ahead of what may prove to be a challenging market environment.

1. Mission Fulfillment

It is critical for an endowment or foundation to clearly spell out its mission, as the mission directs the organization, serving as its ultimate purpose.

A primary concern for endowments and foundations is the management of short-term spending needs, such that these expenditures do not eat into long-term investment goals. In particular, these institutions worry about the effect of investment returns on operations and balancing day-to-day financial obligations with longer-term investment gains. To this end, it is critical to understand the impact of longer-term asset allocation decisions on shorter-term operations. Enter: NEPC's Total Enterprise Management (TEM) model. A pioneer in this field, NEPC employs this model to efficiently bridge the decision-making gap between short-term operational decisions and spending needs, and long-term investment return and risk. TEM considers risk from an organizational perspective, enabling decision-makers to strike the critical balance between providing an adequate, reliable cash flow for today's operating budget and spending commitments, while investing for long-term portfolio performance that supports the organization's future goals. We often find that decision -makers have a difficult time articulating their risk tolerance and stress points. TEM challenges decision-makers to step away from the noise created by the markets and consider risk tolerances and investment philosophy as it relates to their organization.

2. Governance

Robust governance not only ensures the effective implementation of sound procedures and processes, but also it protects fiduciaries when investment performance falls short of expectations. The primary issues regarding governance revolve around policies and guidelines, and the composition of the board or committee. Citing NEPC's governance survey dating back to 2016, the three main challenges facing an institution's governance are:

a) The timeliness of decision making
b) The commitment of the board/committee members, and
c) Lack of investment expertise on the board/committee

In the past, governance structures have come under criticism for being woefully ill-equipped to tackle the complexities of today's capital markets and investments. As a result, fiduciaries seeking to ensure sound governance for their investment programs are increasingly delegating a substantial portion of their responsibilities to third parties with expertise in the field of fund management and administration. These Outsourced Chief Investment Officers, or OCIOs, can help govern investment programs efficiently and effectively.

By the end of last year, endowments and foundations had over $320 billion invested in OCIO models, according to estimates from Cerulli Associates, up from $174 billion in 2014. By 2023, endowments and foundations are projected to represent 30%, or nearly $500 billion, of a $1.7 trillion OCIO market, making them the fastest growing segment of the OCIO universe.

At NEPC, our OCIO capabilities provide clients the peace of mind that comes with knowing their investment program is in the hands of dedicated experts. By delegating the investment management to a third party, boards and committees of endowments and foundations are able to focus their time and attention on strategic decisions that better align with their core competencies.

When it comes to boards or committees, we believe success stems from realizing one's strengths and weaknesses. The ideal size of an investment committee is anywhere from four-to-six members, although many consist of more members. Diversity in terms of race, ethnicity, gender, geography and socioeconomic status provides a different perspective and can be instrumental in helping committees think through critical issues. It is also imperative that there is a clear delineation of roles that identifies which responsibilities lie with the board, committee, and any third-parties involved. Finally, attendance and active participation are required to ensure the effective and efficient running of an investment program.

3. Investment Management

The third pillar of a sound investment plan—integral to the success of the organization's mission—is investment management, which comprises the complex and vital issues of asset allocation, portfolio construction, performance measurement, and impact/mission investing.

Before an asset allocation strategy can be recommended or approved, it is imperative to know the specific circumstances surrounding an institution's investment program. As we mentioned earlier, NEPC's proprietary Total Enterprise Management tool is designed to help organizations stress test various inputs, for instance, the capricious nature of fundraising, ongoing operational needs, debt structure, spending volatility, and return needs and risk tolerances. Stress testing these factors can help determine the appropriate strategic asset allocation mix and how tactical an investment program can be.

While asset allocation is critical to an investment program's success, an often-overlooked piece of the puzzle is portfolio construction. To this end, NEPC has created a portfolio construction team designed to combine the best ideas across research while working with the specific risk and return objectives of each client. Portfolio construction can include the appropriate pacing of private markets and liquidity analysis, sizing, and risk allocations of strategies/managers to ensure optimal beta structure and exposure within asset classes or look-through exposure analyses to consider overlapping exposures or gaps in exposures throughout the portfolio.

Another consideration in investment management that is coming into sharper focus: impact/thematic investing, socially responsible investing, and incorporating environmental, social and governance (ESG) practices into the investment process. At NEPC, nearly 15% of our clients are implementing some form of impact investing in their investment programs. Our Impact Investing Committee works closely with clients to help align their investment portfolio with the impact goals of their organization. Our priority is to understand your missions, return and risk objectives, spending and liquidity needs, so we can help you find an investing approach that achieves both a financial return and a societal contribution. To this end, we have developed a proprietary ESG ratings system to assess the ESG integration of both a firm and a product for our clients. This system was designed to emphasize an investment manager's ability to include ESG factors in the investment process; it uses quantitative and qualitative data at the firm and strategy levels.

The final aspect of investment management is performance measurement. We have observed a recent trend of investors measuring performance based primarily on the risk they are willing to absorb rather than shooting for a particular return target. For example, if an institution has a 7.25% nominal return target, and achieves that return in a year when peers have posted gains of 10%, is that performance deemed successful? In absolute terms, yes; however, relative to peers or relative to the returns offered by the market that year, the answer is a resounding no. Accordingly, we are working with clients through TEM to reframe their perspective of how performance should be measured by understanding the risk(s) they are willing to take each year and trying to maximize the return within those constraints.

CONCLUSION

Endowments and foundations are not resting on their recent investment triumphs; instead, they are proactively thinking about the issues that lie ahead for their investment programs. At NEPC, we look to rise to these challenges and help our clients achieve their long-term financial objectives without endangering the short-term needs of their organizations. Our robust ratio of clients to consultants (only six clients, on average) allows us to focus the time and attention necessary to be a part of a collaborative partnership. As the US economy remains ensconced in the late stage of an economic cycle, we stand ready to walk alongside our clients in pursuit of solutions that will lead to the successful fulfillment of their missions.

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- *Past performance is no guarantee of future results.*
- *All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.*
- *The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.*
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