How Endowments and Foundations Can Better Persevere in a Volatile Environment

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pfm asset management

To gain a better understanding of how Endowments & Foundations (E&Fs) should be navigating the current market environment and to provide greater insight into what PFM Asset Management (PFMAM) is doing to help its clients, we conducted the following question and answer session with the PFMAM National Endowment & Foundation Practice. The E&F Practice consists of Bikram Chadha, Alex Gurvich, Mallory Sampson, Matt Smith and Khalid Yasin.

The current economic environment is quite volatile. How has this impacted E&Fs, and are there any common themes when it comes to client concerns?

Endowments and foundations, by their nature, have long-term investment horizons which should not be impacted significantly by short-term volatility. However, when markets experience severe or protracted downturns (as we are currently witnessing), it may impact an institution's ability to budget spending for mission support while simultaneously preserving true endowment corpus. So, this is a common concern.

In addition, institutions with heavy allocations to illiquid private investments may feel greater pain from the "denominator effect," which can push asset allocation out of policy as liquid asset valuations decline and market value reporting of private investments lag the public markets. This exacerbates illiquidity risk and underscores the importance of periodic asset allocation studies using cash flow analysis and stress-testing to ensure alignment with an institution's long-term goals and objectives.

We believe appropriate diversification and a long-term investment horizon will help institutions endure significant volatility and downturns while keeping them positioned for market upswings.

Does PFMAM see any similarities with historical economic periods, and are there any lessons that endowments and foundations might glean?

If we look back at previous significant stock market declines, periods of high inflation, and/or recessionary periods, we see many similarities in market and asset class behaviors. However, because of the coronavirus pandemic, this cycle is truly unique as it has led to an unprecedented and forced shutdown of economic activity and a corresponding monetary response.

Current inflation stands at roughly 8.5%, and the stock market has declined by approximately 20% as of June 30, 2022. Elevated levels of inflation, low growth expectations, tightening monetary policy and negative consumer sentiment have become a reality. This dour backdrop has led some investors and economists to expect a recession in early 2023.

In fact, according to Bloomberg, a forecast for recession is higher than one in three (close to 38%). However, what makes this market environment truly different from prior periods is that corporate earnings are still positive, company balance sheets are generally considered healthy, the unemployment rate remains historically low and consumer savings are high. This contradictory data is what makes this market so uncertain and challenging to forecast.

Our view is that although inflation may soon peak, it will still be of paramount concern to the Federal Reserve (Fed) in the coming quarters. Further, we expect that the monetary policymaking body will continue its hawkish tone and raise rates and/or reduce its balance sheet in an effort to mitigate potential damage to the broader U.S. economy. By extension, this will undoubtedly impact consumer demand and real growth, and have an impact on whether we as a nation dip into recession. The stock market is considered a forward-looking indicator and will take its cues from both inflation and the Fed's response.

Our job is to monitor macro factors and fundamental data and to develop economic and market views. Although there is a significant level of uncertainty and high volatility, we believe that endowments and foundations should stick with their strategic long-term asset allocation based on projected capital market assumptions and liquidity needs to help endure this period of uncertainty.

What is PFMAM doing to guide its E&F clients through this period of market volatility?

During periods of heightened volatility, we rely on a two-pronged approach to help ensure that our E&F clients are confident in the health of their portfolios — proactive portfolio positioning and high-touch client service. Proactive portfolio positioning begins with an increased frequency of PFMAM's Investment Committee meetings to stay ahead of a rapidly changing investment landscape. Our Investment Committee is tasked with both protecting client capital on the downside and capturing returns on the upside. Therefore, tactical risk-mitigating portfolio changes are explored exhaustively during volatile times like these.

For example, as the Fed increasingly signaled rate increases as disappointing inflation readings began to stack up, our Investment Committee increased our clients' exposure to commodities and REITs (Real Estate Investment Trusts).

History has demonstrated that diversifying return drivers can materially buoy portfolios during a declining market environment, especially one characterized by falling growth projections and rising interest rates. As such, our Investment Committee has embraced the need to be proactive, creative and communicative to navigate periods of heightened volatility successfully.

Further, our relationship managers are empowered to increase outreach to their clients beyond our typical quarterly meetings to field any questions about what is happening in the market and how it may affect their portfolio. This is supported by contemporary thought-leadership (whitepapers, InvestEds, etc.) and ad-hoc webinars to explain our understanding of the prevailing market, our expectations in the short- and intermediate-term, and how this is reflected in our portfolio positioning.

We would also note that extraordinary market events often spur a need for additional client education sessions. For example, certain clients' governing committees may be unfamiliar with the experience of rapidly increasing inflation and the corresponding impacts on the capital markets. In this situation, the client's relationship manager may present a historical review of previous eras of high inflation, highlighting similarities and differences in the causes of inflation and the actions previously taken to resolve the situation. In this way, our clients may better contextualize the current market environment, brace for the potential impacts and ultimately remain confident that their advisor is working diligently seeking to optimize the health of their portfolio.

Finally, we should point out that tactical shifts, the use of inflation hedges, and the utilization of low-cost passive management (ETFs or index funds) helps reduce overall investment program costs and improve returns (net of fees), especially during periods of elevated inflation. We prefer to anchor portfolios with passive management in efficient asset classes such as U.S. large-cap and developed non-U.S. equities, reserving higher fee active managers for less efficient classes where we have higher conviction in managers to potentially outperform net of fees.

What should Endowments and Foundations be thinking about, and/or what should they consider doing to help mitigate concerns and persevere in the coming months?

While it is often quite difficult to ignore headlines around market volatility, geopolitical risk, and inflation, it is imperative to remember what is most important to an E&F as an operating entity. The primary focus of these institutions revolves around having adequate liquidity to cover spending policy obligations.

Therefore, having strategic policy discussions about spending, target asset allocation/return and the choice of variables that are part of these calculations are important governance practices, not just now but annually. For example, a target return calculation often incorporates an inflation variable such as CPI (Consumer Price Index) or the typically higher HEPI (Higher Education Price Index). An institution should determine the most appropriate index based on its unique needs.

In addition, a primary component of spending policy calculation is a time period (number of quarters, years, etc.) Adjusting to a longer time period allows for market value smoothing for spending policies and can help both preserve endowment corpus and reduce the risk of market and spending volatility. An additional idea that may work for some is establishing a reserve fund during periods of outperformance. Comprised of 12-18 months' worth of operating and grant-making expenses and invested in high-quality short-term Treasuries or CDs, a reserve fund may be used to augment spending needs during bear markets, while allowing an institution to invest its main portfolio more aggressively with greater illiquidity for the long-term and minimal duplication of fixed income assets. This can also provide the institution with "peace of mind" and allow for operational and mission support without disruption or selling underpriced securities.

For more information about this report, don't hesitate to get in touch with your PFMAM representative.