Latest Endowment Study Shows Single-Digit Decline in Returns in FY2022

Long-Term Results Remain Challenged

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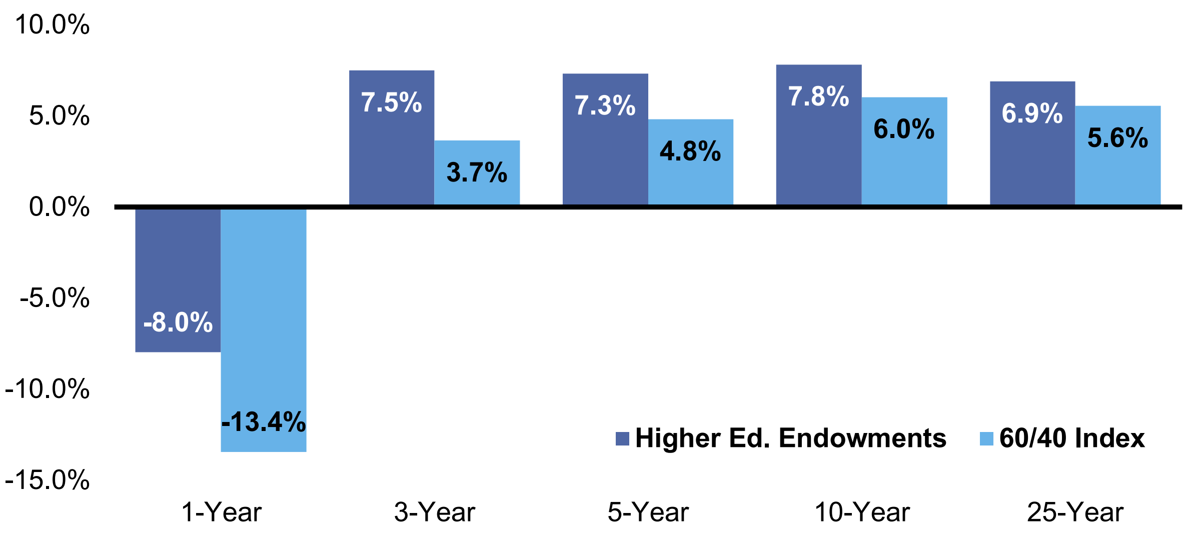
pfm asset management

In a year marked with volatility, Endowment returns outperform 60/40 portfolio for both Fiscal Year 2022 and over 10-Year Period[1]

According to the 2022 NACUBO-TIAA Study of Endowments (NTSE) published earlier this year, U.S. higher education endowments returned -8.0% on average for the fiscal year (FY) ended June 30, 2022. This is a marked change from the more than 30% return that was reported in FY2021. As a result, the 10-year annualized rate of return declined from 8.5% in FY2021 to 7.8% in FY2022. Meanwhile, the longer-term 25-year annualized return declined from 7.4% in FY2021 to 6.9% in FY2022.

While higher education endowments experienced challenged returns, PFM Asset Management (PFMAM) compared NTSE's return of -8.0%% to the -13.4% annual return of a balanced 60/40 portfolio (60% MSCI ACWI (net) Index and 40% Barclays Aggregate Index). The outperformance by endowments relative to this 60/40 index can be partially attributed to lower public fixed income allocations, averaging 10.7% that were particularly challenged in a rising rate environment. In addition, endowments maintained sizeable exposures to alternatives such as private equity, venture capital, private real estate, and other real assets, which may have allowed them to better weather the market volatility experienced in 2022. Although, this outperformance may also be attributable in part to stale pricing and accounting rules that do not require daily mark-to-market pricing for private assets.

Average Annual Returns for U.S. Higher Education Endowments Compared to a 60/40 Index[1] as of June 30, 2022



2022 NTSE.

1 Endowments as represented by the 2022 NTSE. Returns are net of fees. 60/40 Index as represented by the 60% MSCI ACWI (net) Index and 40% Barclays Aggregate Index.

Effective Spending Declines

The 678 surveyed institutions reported an average annual effective spending rate of 4.2% in FY2022. That marked an almost 13% decline from 4.8% in FY2021.

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Average (All Institutions)	4.20%	4.40%	4.40%	4.20%	4.30%	4.40%	4.40%	4.50%	4.60%	4.80%	4.20%

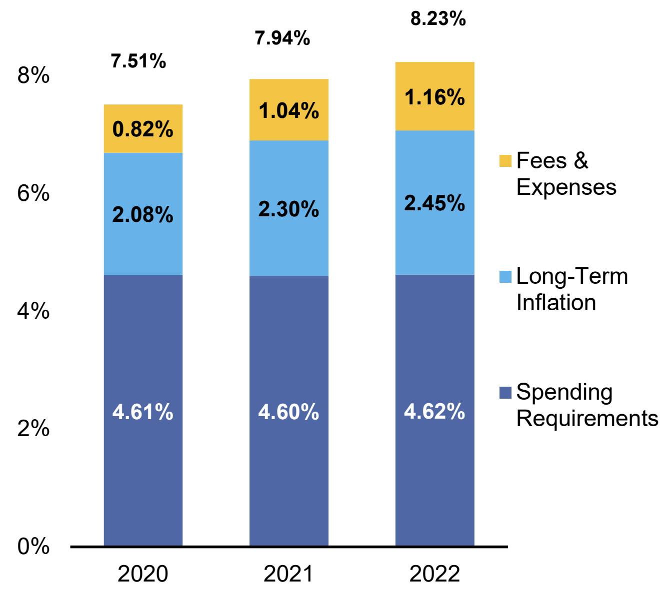
2022 NTSE. All data is reflected as of June 30 each year-end. The effective spending rate represents the distribution of spending divided by the beginning market value (endowment value on or around the beginning of the fiscal year). The distribution for spending is the dollar amount withdrawn from the endowments to support expenditures on student financial aid, faculty research, maintenance of facilities and other campus operations, as determined and defined by each institution. The rate is calculated net of any investment fees and expenses for managing the endowment.

Across all institutions, student financial aid accounted for 46% of spending policy distributions in FY2022, while campus operations and maintenance accounted for 10% of spending. In total, academic programs and research, endowed faculty positions and "other" accounted for 44% of spending.

Fees and Inflation Continue to Drive Hurdle Rates Higher

Many institutions are feeling the pinch of higher post-pandemic inflation and growing expenses related to actively managed funds and alternative investments. Given these new realties, the long-term target rate of return for institutions has continued to climb from the traditional 7.5% hurdle last seen in FY2020 to 8.23% as of FY2022.

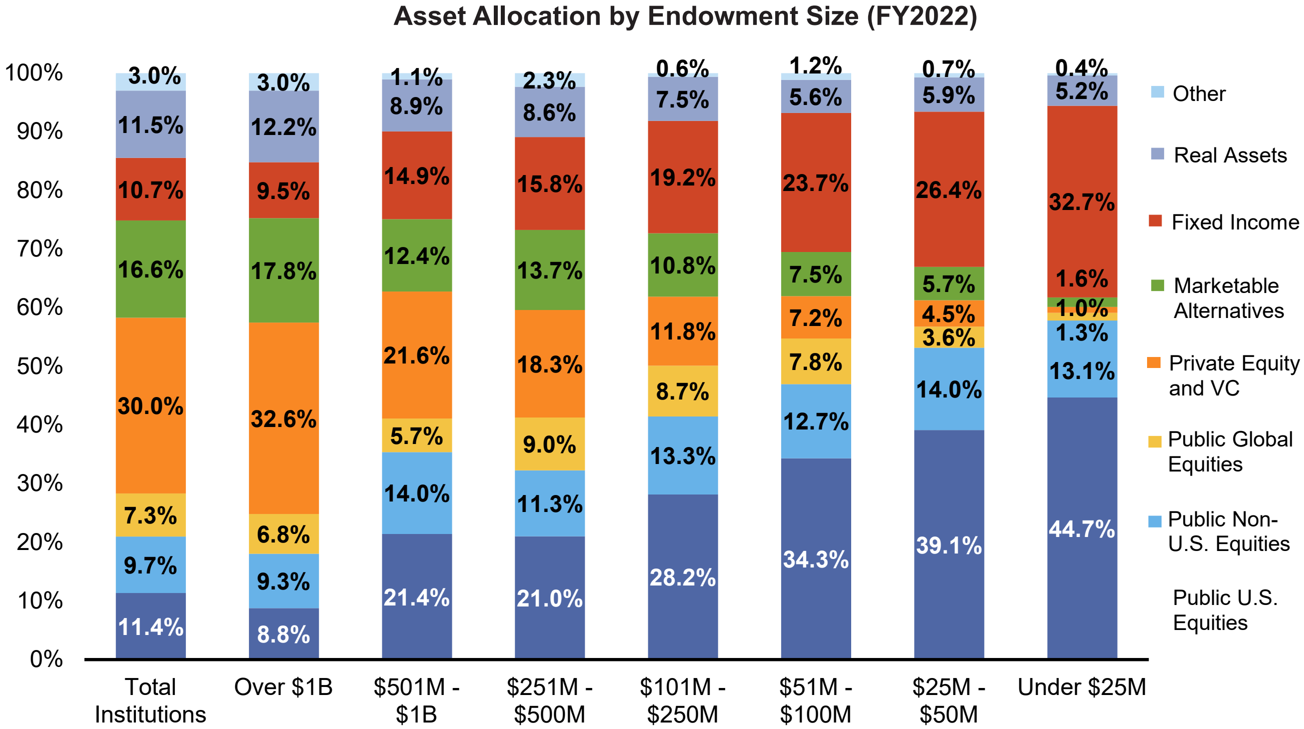
Unfortunately, rising return targets are at odds with declining return expectations. PFMAM's expected 30-year annual rate of return for domestic equities is 7.7%, which means that even an entity fully allocated to equities could potentially struggle to meet their return needs and generate returns below the new long-term target for endowments. As a result, unless spending budgets or fees can be reduced, endowments may need to review their strategic and tactical asset allocations to help close the gap.



2022 NTSE.

Asset Allocation

Large endowments with greater than $1 billion in assets allocated nearly 33% of their funds to private equity and venture capital investments, compared to a less than 1% allocation for endowments with under $25 million in assets. These allocations arguably benefited larger institutions in FY2022, where the average yearly return for endowments with over $1 billion in assets was -4.5%, compared to -11.5% for endowments with less than $25 million in assets. However, as stated previously, part of this may be attributed to pricing lags related to private assets.



2022 NTSE.

Responsible Investing and DEI Initiatives

In FY2022, 86.5% of institutions that responded to the study included ESG in their investment policy, which is over 6% higher than last year.

Interestingly, 41% of institutions in the largest surveyed cohort considered responsible investing as a potential source of alpha, compared to only 10% of the smallest endowments. However, actual implementation of ESG/SRI/Impact Investing strategies do face some notable headwinds. The 2022 study highlights that 24% of respondents are concerned about the "potential adverse impacts on investment performance".

On diversity, equity, and inclusion (DEI) initiatives, nearly two-thirds of participants voiced that some level of gifts in FY2022 were tagged to support DEI initiatives. Additionally, the number of institutions reporting that they had a formal DEI policy relating to manager selection increased to 9.6% in FY2022 from 7.7% the prior fiscal year.

Our View

As we continue to face an evolving and uncertain market environment, with an expectation of challenged investment returns over the intermediate-term and long-term, we believe that it is important for institutions to remain up to date with their investment and spending policies. Here are a few considerations in view of the latest NTSE study:

- With the pressure to raise return requirements to help offset fees and inflation, institutions may consider reducing their investment management fees or optimizing their asset allocation based on the latest capital market assumptions.

- While returns for alternative investments are attractive, their higher fees, difficulty accessing top tier managers, and wide dispersion of returns between top and bottom quartile managers make it imperative for institutions to carefully weigh the potential costs and benefits of allocating to this asset class.
- Institutions still relying on a 12-quarter smoothing period for their spending policy may consider changing to a longer "smoothing" period such as seven years. Our studies show that a longer smoothing period leads to more balanced outcomes.[2]
- Regarding DEI and the inclusion of minority managers in an investment portfolio, there may be barriers inadvertently placed on minority managers excluding them from typical manager searches. Endowments may benefit from including these managers.[3]

PFMAM stands ready to provide investment advice and solutions to our endowment, foundation, and non-profit clients in this dynamic investment environment. And we look forward to learning more about your organization and how we can serve you.

2 *Please read our previous InvestEd about spending policy, Spending Policy 2.0: Understanding the Historical Impact of Spending Calculation Rules on Endowments (From 1970 to 2020).*

3 *Please read our previous InvestEd about minority managers and ESG, Multi-Asset Class Minority Manager Investing.*

For more information, please email our Endowments & Foundations National Practice at EFNP@pfmam.com or contact your PFMAM representative.

All data from the 2022 NACUBO-TIAA Study of Endowments (NTSE) unless otherwise noted.