STRATEGIC EXCHANGE

# TEN GUIDING PRINCIPLES FOR FOUNDATION INVESTING

The Holy Grail for investing is to make money when markets are rising and not lose money when markets decline. A simple enough plan that is difficult to achieve. This article examines ten guiding principles to help endowments and foundations develop their investment plan, and tackle an evolving investment landscape.

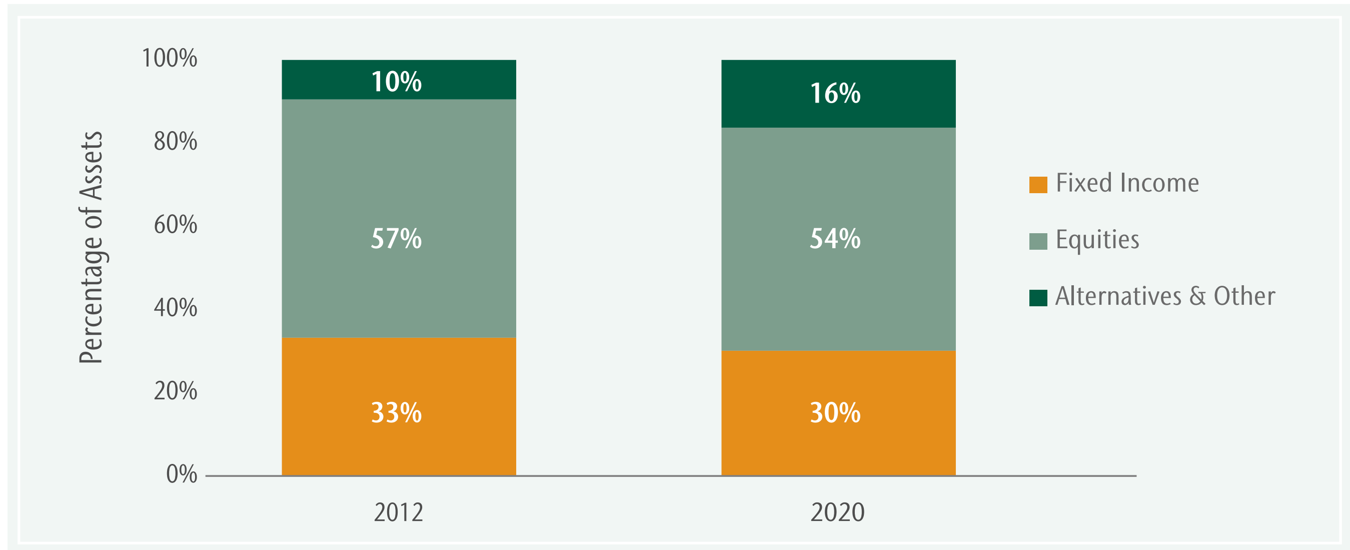
## Investment Landscape

When building an investment plan for an endowment and foundation, the typical main categories of investments are – income, growth and diversifying assets. It is a much different investment landscape today compared to 15 years ago, when the typical asset mix was 60% equity/40% fixed income. As a result, there has been a significant change in the role, composition and weighting to these categories.

- **Income Assets**: Historically, traditional domestic fixed income almost exclusively fulfilled a portfolio's income requirements. With a multi-decade decline in bond yields, fixed income return expectations have greatly reduced. The lower return expectation has led to the introduction of higher yielding and non-domestic strategies, as well as non-fixed income strategies under the income category.
- **Growth Assets**: Equities continue to account for much of the growth component, although the opportunity set has broadened beyond domestic and global large capitalization equities to include asset classes such as global small cap and emerging markets.
- **Diversifying Assets**: The decline in bond yields has also resulted in a reduction in the diversification benefits from fixed income, and the increased risk of negative returns in a rising interest rate environment. In response, many investors have looked to alternative investments to help manage volatility and achieve their total return targets. Alternative investment diversifying assets have included direct real estate and infrastructure, as well as absolute-return focused strategies, such as market neutral hedge funds.

The response to this changing landscape has seen many investors move from the typical 60% equity/40% fixed income allocation, to introduce alternative investments, which have grown to represent an average of 16% of total endowment and foundation assets in 2020. (Figure 1).

**Figure 1 – Evolution of Endowment & Foundation Policy Asset Mix**




Source: Mercer

For Board and Committee members, it may feel like there is always a new challenge to tackle when overseeing an investment portfolio. Commonly discussed items include the challenge of lower bond yields and the implication for fixed income returns, as well as the role of responsible investing and how to integrate environmental, social and governance (ESG) factors into a portfolio. The following guiding principles provide a general framework for investing and serve as a checklist to help assess current challenges and considerations.

## Guiding Principles

1. **Establish a regular spending formula and stick to it.** While the recipients of grants will appreciate the consistent cash flow, it is important to recognize the link between the level of spending and the asset mix risk and return profile. For example, to support a spending target of 3.5% implies a different asset mix and associated risk and return profile when compared to what is required to meet a spending target of 5.5%.

2. **Adopt a total return approach.** The temptation when considering a potential investment is to focus on the expected yield or income, since it can be one area the investment manager has some control over. Instead, focus on the total return opportunity by considering a combination of income and capital growth when developing the asset mix. With the decline in bond yields, relying on income alone to meet spending needs is unlikely to be an adequate solution.

3. **Do not be too conservative.** Push yourself and get comfortable with a little more risk. As bond yields have declined, changes to the asset mix were necessary in order to achieve the same return. The acceptance of greater short-term volatility or less liquidity when investing in private markets (such as real estate and infrastructure) can provide much needed additional return. While equities and fixed income have held up well relative to more complex asset allocations, in today's market environment, the odds are greatly stacked against this continuing.

4. **Diversify.** Never before has including uncorrelated assets that behave differently at different times been so important. Diversifying assets provide a more reassuring and effective approach to smooth out the return experience at the total portfolio level by helping manage the level of potential drawdowns in extreme market declines.

5. **Understand what your investment manager is doing.** Confidence is key to managing anxiety levels in tough markets and periods of shorter-term underperformance, as well as assessing new strategies. Therefore, make sure you make time on agendas for high-level strategic discussions, and the role of new strategies. To better understand the integration of ESG factors into your portfolio, have a discussion with your investment manager, including the type of related reporting that is available.

6. **Understand the role of delegation.** The concept of delegation is not new. Most endowments and foundations delegate the day-to-day investment management of their portfolios to third-party investment managers. However, with more complex asset mixes required to meet return goals, the investment industry has responded by offering a range of delegation options to take on more of the investment decision-making and associated administration. More delegation may make sense for some endowments and foundations, but it is important to remember that the Board and Committee retains the fiduciary responsibility for the final decisions.

7. **Do not buy on performance or fees alone.** Performance and fees provide insight into the past and are often considerations to help identify a short list of managers. At the short-list interview stage, the key is to ensure there is a robust selection process that includes qualitative considerations to identify the differentiating factors between the managers, such as the role of the ownership structure at attracting and retaining professionals, the clarity and repeatability of the investment process, and the stability and diversity of the investment teams. A reasonable assessment goal is to identify an investment manager with whom you can relate and have confidence in.

8. **Do not be trigger-happy.** There will be periods of good relative performance, but also periods of shorter-term underperformance. If a manager is underperforming, first look to understand why. For example, is underperformance explained by the investment approach being out-of-favour in the current environment? If so, how does the performance rank relative to their investment style peers? It can be helpful to refer back to the reasons you selected the investment manager in the first place and to check whether the portfolio characteristics are consistent. All other things being equal, giving the investment manager the time and chance to recover lost ground can avoid an expensive "buy high and sell low" experience.

9. **Do not sit on cash.** Historically, cash was a fixed component of an asset mix and used to meet cash flow needs. However, a long-term asset mix policy allocation to cash can be a drag on the total portfolio return. There are other more efficient approaches to meeting cash requirements, such as through income and dividend distributions, and through the rebalancing process when trimming asset classes that have outperformed and represent a higher weighting compared to their asset mix policy weights. Similarly, when capital is set aside for a specific project, cash has been a natural consideration for ensuring the capital value is available when needed. However, if the time horizon for the cash is lengthy, the foundation may be shortchanging itself by having a conservative policy.

10. **Raise more money from your donors.** The larger the market value of assets, the greater the dollar benefit generated from investment returns. Donor engagement is another key component to achieve a foundation's mission or goals rather than counting too heavily on investment returns alone.

## Meeting the Challenges of Change

The investment landscape has dramatically changed over the last number of decades. As a result, to achieve the same return today compared to 15 years ago requires a very different asset mix. By drawing on the guiding principles shared in this article, Boards and Committees have a framework to rise to the challenges of a changing investment landscape.

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