STRATEGIC EXCHANGE

ENDOWMENTS AND FOUNDATIONS

INVESTING FOR THE NEXT DECADE

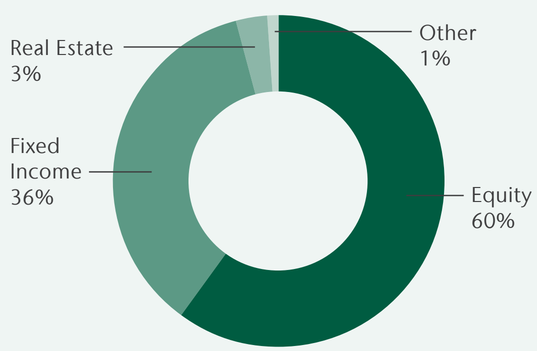
A fairly common approach in the US, that you are less likely to see in Canada, is outsourcing investment management of endowment and foundation assets to a third party. Interest in outsourcing is starting to gain momentum here. But if outsourcing is the solution, what was the problem?

What Problem?

Given the recent strong returns of traditional balanced funds, you would be forgiven if your reaction was "what problem?" The median balanced fund performance, invested roughly 60% in equities and 40% in fixed income, returned over 10% for the 4-year period ended September 30, 2015.

The current average asset mix for Canadian endowment and foundation portfolios is fairly close to the 60/40 balanced fund mix with the only variation being a small allocation to real estate (Chart 1).

Chart 1 – Endowments and Foundations Average Asset Mix



Sources: Mercer 2014 Canadian Endowment & Foundation Survey: Funds $100M to $250M

For decades fixed income has been an asset loved by investors and continues to be a major fixture in portfolios. However, in today's low interest rate environment with an expected long-term return of approximately 2% for a universe bond index, the problem is not the past, but the outlook for the future.

The expected return for a balanced fund is approximately 6.2%, which on the surface doesn't look too bad. However, the typical spending rate of endowments and foundations is in the 3-5% range. Now, the situation doesn't look that good for an endowment operating in perpetuity with a spending rate of 4%, expected inflation of 2% and 0.5% expenses. This expected return offers no capital growth.

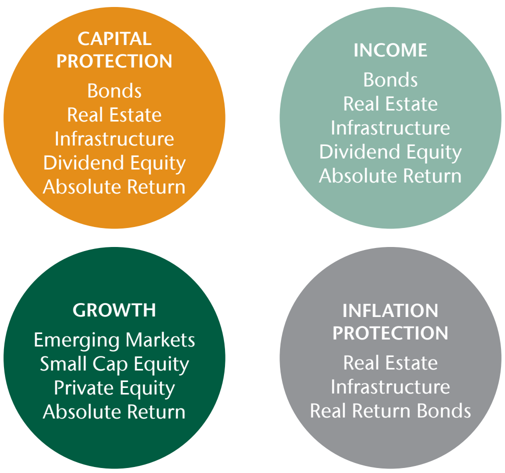
One solution could be to consider a higher exposure to equities to improve returns, but investors have become increasingly sensitive to the higher volatility when seeking greater returns through equities.

Shift to Needs Focus

Success in the future requires a shift from a focus on returns to a focus on the needs of endowments and foundations, which for most will be a combination of capital protection, income, growth and inflation protection.

Associated with each of these needs is a range of asset classes (Chart 2). For example, in the capital protection category there are traditional bonds, real estate, infrastructure, dividend equity or low volatility equity strategies and absolute return focused funds.

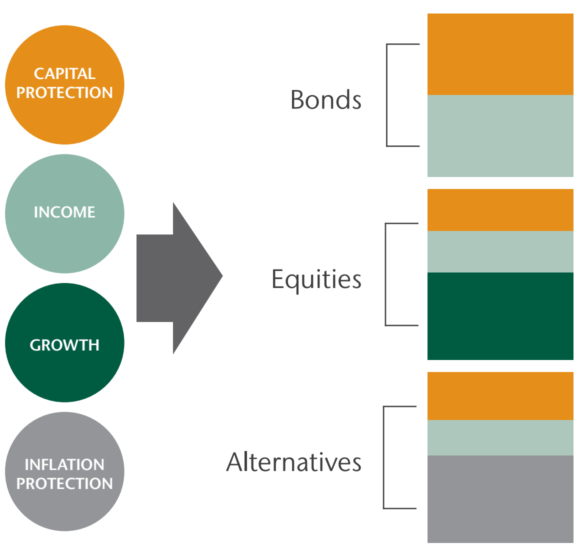
Chart 2 – Matching Needs and Assets



There are also appropriate assets for each of the income, growth and inflation protection categories.

A tailored asset mix based on weighting a fund's needs may be developed to meet its overall objectives (Chart 3).

Chart 3 – Establishing Asset Mix



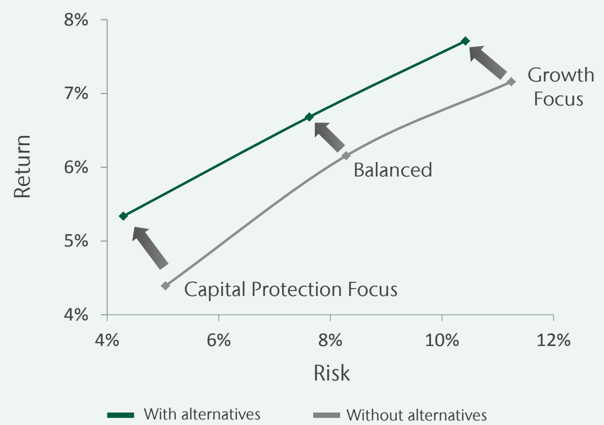
The same approach can be applied to funds with different time horizons and cash flow requirements to customize an asset mix.

The Alternative Advantage

A needs-based analysis suggests an important role for alternative assets, such as real estate, infrastructure and absolute return strategies. Alternatives complement traditional assets and can improve expected returns due to the nature of the asset and how its returns are achieved.

Chart 4 displays an efficient frontier plotting the range of risk and return points for different portfolio profiles - ranging from a capital protection focused portfolio to a growth focused portfolio.

Chart 4 – Efficient Frontier*



*Return and volatility are based on 10 year forecasts for the various asset classes within the model portfolios. Portfolios with alternatives includes an allocation of 5% Real Estate, 5% Infrastructure and Absolute Return Multi-Strategy. Multi-strategy allocation is 18% for the Capital Preservation portfolio, is 9% for Balanced and 14% for Growth Focus.

Introducing alternatives increases the return while reducing the risk as a result of the complementary characteristics of real estate, infrastructure and absolute return funds to traditional asset classes.

The balanced fund with alternatives is expected to achieve a similar return to the growth focused portfolio without alternatives, but with two-thirds the volatility.

While there's a good case to be made for alternatives, Canadian funds have not yet embraced these investments, except for a small allocation to real estate. In the US, funds in the US $100 to US $500 million range allocate, on average, over a third to alternative investments. Even funds in the US $25 to US $50 million range have an average of 20% allocated to alternatives.

Size, therefore, is not necessarily a barrier to investing in alternatives, but it's not without its challenges. Implementing your investment program is more complex than ever before, given the growing number of strategies and asset classes to consider. This may be further complicated by the volunteer committee structure generally adopted by endowments and foundations, where meetings tend to occur infrequently.

While the nature of the assets utilized by Canadian endowments and foundations has not changed much over the last decade, many investment firms have evolved to include a much broader range of traditional equities and fixed income, as well as specialist investment teams to provide a range of alternative investments.

This evolution enables investors of varying sizes to access a much broader range of investments and with the benefit of an integrated operational and compliance support structure.

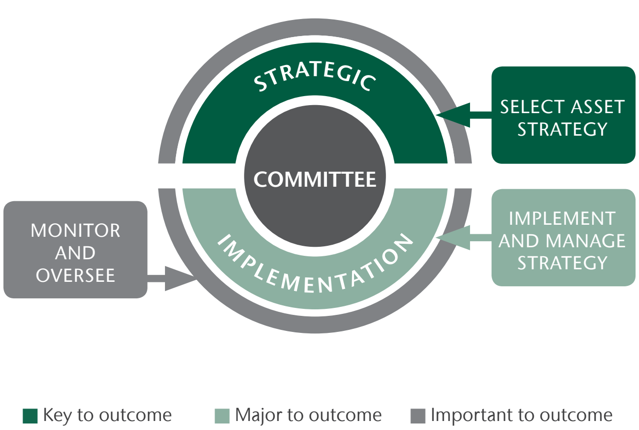
There has also been an evolution in the investment consulting industry with many of the larger consulting firms operating an investment outsourcing business alongside their non-discretionary advice business.

Role of Outsourcing

Given the needs of investors and the additional resources of investment managers and consultants, is some form of outsourcing appropriate?

Perhaps the best way to answer the question is to consider where the committee's time is best used from a reward perspective in the governance process (Chart 5).

Chart 5 – Time vs. Reward Expectations



Key to a favourable (or unfavourable) outcome is at the strategic level where the asset strategy is formed. The strategy reflects a fund's unique spending policy and risk tolerance based on tailored weightings to income, capital protection, growth and inflation protection goals.

The next major contributor to the outcome is the implementation stage which determines the level of additional return from active management, as well as overall risk management. And finally there is the monitoring stage that provides a check on how the strategy and implementation is working versus expectations.

Today, too much time is generally spent on the monitoring stage at the expense of strategy. Outsourcing can free up time to spend on strategic decision making, and it does not have to be an all or nothing choice.

A few governance guiding principles to help assess what may make sense for your governance structure.

- Strategic
  - Is there a willingness to consider new strategies that may be needed to meet your future goals?
  - Is there a documented position with respect to environmental, social and governance (ESG) issues?
  - Is the role of asset mix from both a return and risk perspective well integrated?
- Implementation
  - Is the committee open to accommodating additional mandates that may also prove more complex?
  - Does the committee make timely decisions when managing the asset and manager mix?
- Monitoring
  - Comparison of actual performance relative to expectations from both the asset strategy and implementation level, is it working?
  - Is the committee timely in responding to changes that may be required?

For a committee that answers positively to each of these questions, the current approach should be fine. An element of outsourcing may be worth considering where challenges in the implementation and timeliness in response are identified. If the existing governance structure is not flexible in allowing for new strategies to be considered and introduced, then it would be appropriate to review a greater level of outsourcing.

Future Success

The investment outlook suggests that while the experience of the recent past has been good for an asset strategy invested in equities and fixed income, future success will require greater diversification to compensate for lower expected fixed income returns.

Establishing a suitable asset strategy does not have to be wrapped in mystery. The asset mix can be developed based on a fund's tailored requirements for capital protection, income, growth and inflation protection and investing in assets that complement these needs.

The key factor to success going forward is how well you execute at the strategic level, so make sure your governance structure allocates sufficient time to this area.

Finally, identify the pitfalls in your governance to see if an element of outsourcing may be an appropriate solution for future success.

For more information on investing for the next decade contact:

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