Manulife Investment Management

# OCIOs offer resilient solutions for endowments under siege

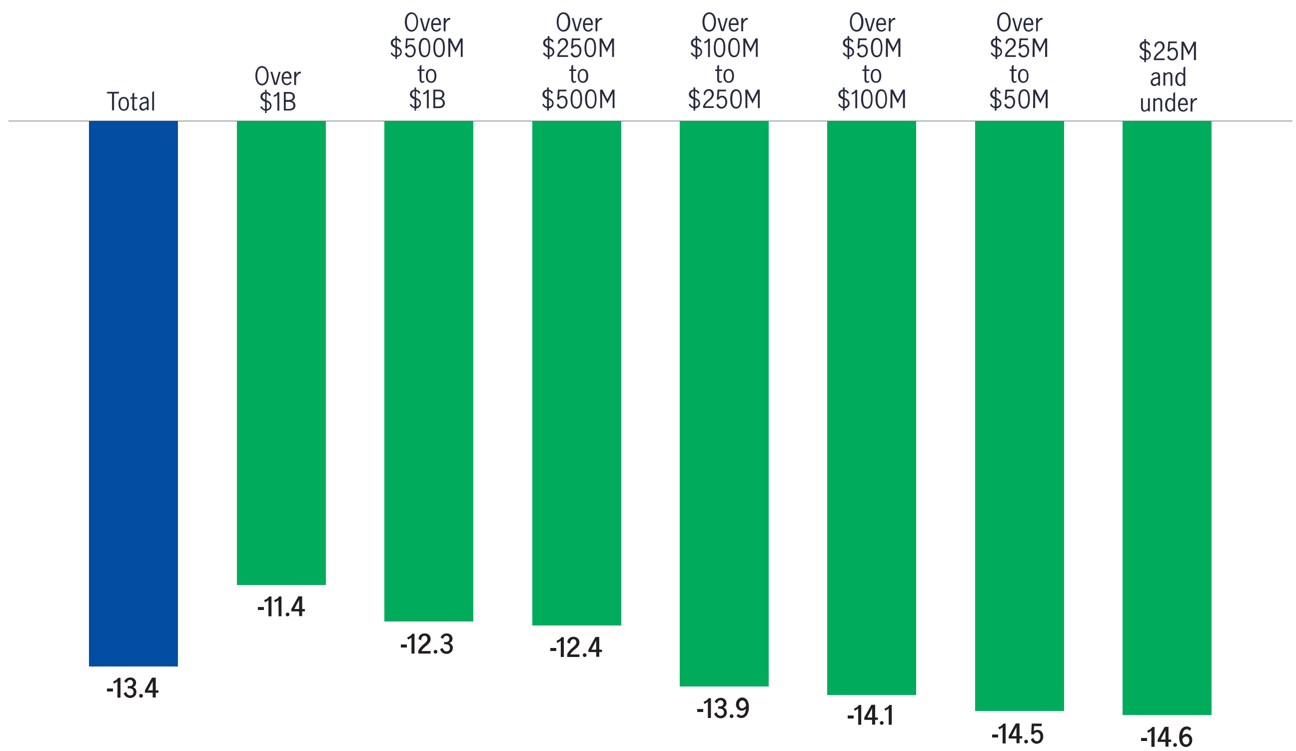
Colleges, universities, and affiliated foundations must now contend with a confluence of constraints stemming from the global health pandemic. Economic recession threatens charitable contributions and state support. Reduced in-person enrollment puts tuition payments and other revenue sources at risk. The fast fall in demand for fossil fuels raises the stakes in energy divestment calls from climate activists. Meanwhile, volatile markets, along with record-low interest rates, complicate longstanding asset allocation and spending policies designed to help fund annual operating budgets. While mission-driven institutions must adapt and meet the extraordinary circumstances of the moment, permanent capital—invested to balance spending needs now and into perpetuity—can't concede too much to current challenges without compromising intergenerational neutrality. Caught between competing claims of scholars of today and those of tomorrow, it's no wonder so many endowment investment offices seem spread so thin. The good news is they don't have to go it alone.

## Smaller endowments suffered bigger losses at the onset of the lockdown

For many endowments and foundations, this year has evoked unnerving reverberations of 2008's global financial crisis. We saw market prices fall and correlations rise as risk assets sold off and once again undermined the tenets of conventional diversification. According to a NACUBO survey of reflecting responses from 333 institutions, the estimated rate of return for U.S. endowment funds in the first quarter of 2020 averaged a net negative 13.4%, rendering roughly one out of every five underwater, when the endowment's market value "falls below the original gift amount."[1] Bigger funds, more likely to benefit from a singularly focused army of in-house asset class experts, lost comparatively less. But smaller peers—some overseen by a lone CFO shouldering a variety of additional noninvestment responsibilities—suffered disproportionately. During the first quarter, the average return spread between the largest funds, over $1 billion, and the littlest, under $25 million, was about 320 basis points.[1]

### Smaller endowments experienced larger losses in the first quarter of 2020

Average estimated net investment rates of return (%)
December 31, 2019–March 31, 2020, by endowment size (USD)




Source: nacubo.org/Research/2020/COVID-19-Research/Q1-2020-Endowment-Survey, June 12, 2020.

[1] nacubo.org/Research/2020/COVID-19-Research/Q1-2020-Endowment-Survey, June 12, 2020.

## Tuition and other revenues remain at risk

One of the most pressing problems for higher education endowments now is how to meet spending policy requirements given volatile markets, low interest rates, and anticipated declines in tuition and other sources of income. Nearly 8 out of 10 institutions are concerned or extremely concerned about declines in enrollment and, by extension, tuition and other enrollment-related sources of revenue. The majority also remain concerned or extremely concerned about decreases in annual giving, and 4 out of 10 are concerned or extremely concerned about declines in state funding.[2]

### Most institutions are (extremely) concerned about enrollment, revenue, and the future

Participating institutions that report concern about liquidity-related challenges (%)

| Liquidity-related challenge | Not at all concerned | Somewhat concerned | Concerned | Extremely concerned |
|---|---|---|---|---|
| **Enrollment decline** | 4 | 19 | 32 | 46 |
| **Loss of other auxiliary reverue** | 5 | 19 | 41 | 35 |
| **Uncertainty about the future** | 3 | 16 | 47 | 35 |
| **Decline in state funding** | 45 | 19 | 15 | 21 |
| **Loss of summer auxiliary revenue** | 15 | 27 | 39 | 19 |
| **Decrease in annual giving** | 4 | 42 | 38 | 15 |
| **Decline in athletic revenue** | 49 | 25 | 16 | 10 |
| **Decrease in endowment value** | 11 | 43 | 37 | 9 |
| **Faculty and staff benefit obligations** | 27 | 39 | 26 | 8 |
| **Loss in clinical revenue** | 75 | 17 | 5 | 4 |
| **Decline in research activity** | 68 | 25 | 6 | 1 |

Source: nacubo.org/Research/2020/COVID-19-Research/May-26-Flash-Poll, May 26, 2020.

[2] nacubo.org/Research/2020/COVID-19-Research/May-26-Flash-Poll, May 26, 2020.

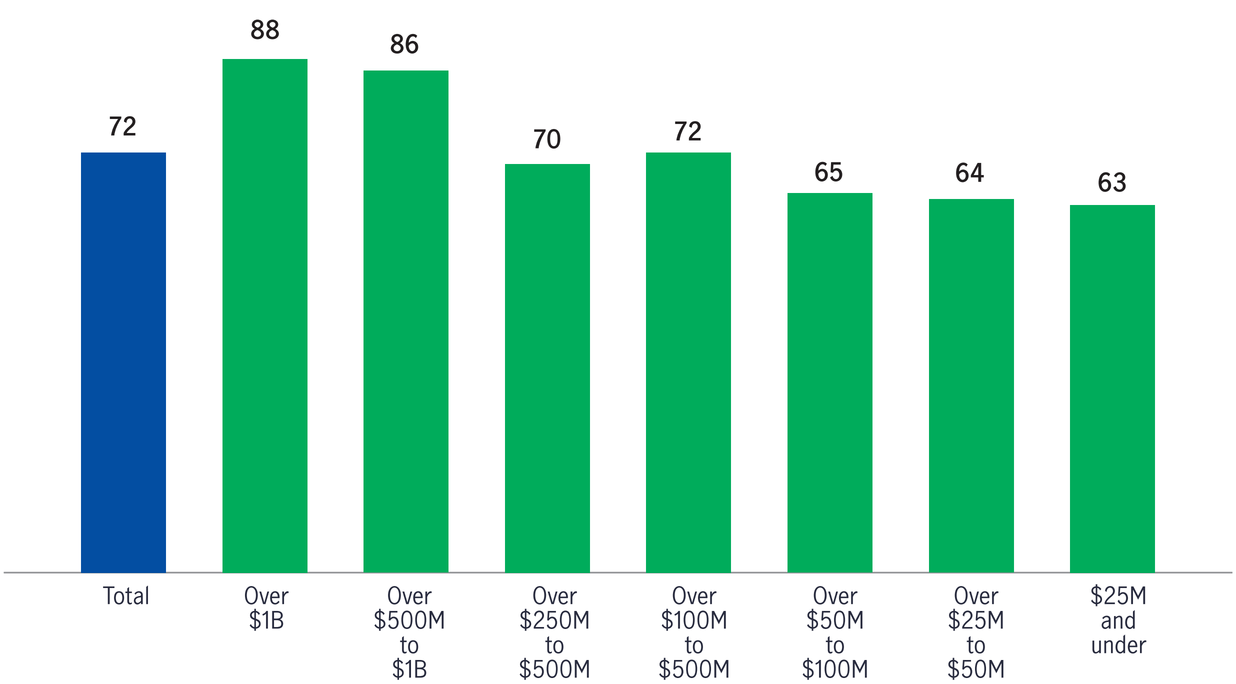
## Some spending policies are now unlikely to stick

Complicating expected revenue shortfalls further, expected returns remain low across most mainstream asset classes. Central bank intervention worldwide has pinned short-term policy rates near zero with no hikes in sight, while asset purchases have kept a lid on longer-term government bond yields, too. While the 10-year U.S. Treasury note now yields a nominal 0.7%,[3] the average expected spending rate for fiscal year 2019 was 4.5%.[1] Even high-yield corporate bond prices that sold off to yield low double digits in March are once again trading at spreads of only a fraction of their peak, suggesting investors might not be receiving adequate compensation for bearing below investment-grade credit risk today.

With all these constraining factors at play, upholding current spending policies is no longer a given. While only 1 out of 10 among the biggest endowments (over $1 billion) expect to alter their spending policies, 4 out of 10 schools with the smallest endowments (under $25 million) likely can't maintain their current spending policies.[1] Many endowments urgently need to reassess their liquidity profiles, update their cash flow projections, and review their risk management strategies.

### Institutions with smaller endowments are less likely to maintain their spending policies post-pademic

**Institutions that expect to maintain spending policy in fiscal year 2021, by endowment size (%) (USD)**




Source: nacubo.org/Research/2020/COVID-19-Research/Q1-2020-Endowment-Survey, June 12, 2020.

[1] nacubo.org/Research/2020/COVID-19-Research/Q1-2020-Endowment-Survey, June 12, 2020.
[3] wsj.com, October 2, 2020.

## Strategies for meeting the moment and building long-run resiliency

Given that the investment horizon for the typical endowment is perpetuity, permanent capital can't concede too much to current challenges. It takes discipline to manage an endowment for long-term keeps amid the pain of the moment. In some cases, it may also take outside help.

Not every institution of higher learning can afford to maintain a large in-house investment department. Many are seeking the help of outside expertise to be able to meet current spending needs, on the one hand, and grow the principal into perpetuity, on the other hand. Outsourced chief investment officer (OCIO) providers can offer comprehensive services that combine advice, risk modeling, sustainability stewardship, strategic divestment planning, custody, asset allocation, portfolio management—and access to niche investment opportunities including:

- **Private credit for capital preservation and premium yields**—Private credit investors provide debt capital financing—direct loans—to companies that may not have access to bond markets. In exchange, the lender receives interest payments and principal repayment. Senior loans reside at the top of a company's capital structure. That means the investors holding them get paid first—before the company's subordinated debtholders and its equity owners. Senior secured private credit provides a compelling solution for long-term investors seeking to preserve principal while capitalizing on the illiquidity premium to earn a yield-spread advantage over otherwise comparable mainstream fixed-income issues.
- **Real assets for inflation protection**—Private real assets include investments as diverse as airports, apartments, dams, farms, forests, and warehouses, yet they all share two defining features. First, they're not publicly traded, and therefore they offer the potential to earn an illiquidity premium over mainstream markets. Second, their intrinsic value is rooted in what's concrete, enduring, and essential. Unlike more cyclical financial assets, this tends to make real assets less vulnerable to unexpected changes in inflation, consumer preferences, and global growth. When chosen carefully, certain real assets—real estate, timber, agriculture, and infrastructure—can also generate long-dated inflation-adjusted income streams. In fiscal year 2019, the average endowment allocated over 12.3% to real assets on an asset-weighted basis. However, smaller endowments (under $25 million) remain disproportionately underweight with an average allocation of only 3.2%. Meanwhile, the largest players (over $1 billion) allocate over four times more to the category.[4]
- **Private equity for alpha potential**—Some of the most sophisticated institutional investors have been shifting portfolio allocations toward private equity and away from public equities for years. The dollar-weighted average allocation of all U.S. higher education endowments to private equity quadrupled—from 3% to 12%—between 2002 and 2019, while the allocation to domestic public equities declined by over half—from 37% to 14%—during that period.[5] The reason is that, relative to listed public equities, regression analysis reveals that private equity performance has been driven more by alpha and less by beta.[6] Again, the illiquidity premium—the reward investors earn for bearing the risk of holding assets that can't be easily traded—represents a meaningful prospective source of private equity alpha.

While there's no silver bullet that will address all the budgetary and capital market challenges endowments are up against today, there are strategies that can help insulate portfolios from capital losses, generate real income in a low-yielding environment, and integrate new sources of alpha. Reliance on such strategies—and the OCIOs who can wield them most effectively—may be increasingly important in the brave new world that lies ahead.

[4] nacubo.org/Press-Releases/2020/US-Educational-Endowments-Report-5-3-Percent-Average-Return-in-FY19, January 30, 2020.
[5] nacubo.org/Research/2020/Public-NTSE-Tables
[6] "Wisdom in Curiosity," KKR Global Institute, October 2019.

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