2019 State of Endowments: Past, Present, and Future

The investment objective of an endowment may vary depending on the overall mission of the organization, but the underlying fundamentals are typically the same, that is, to grow the endowment at least fast enough to maintain or increase distributions while keeping up with inflation. That is much easier said than done. Prior to the last recession, endowments had a reputation for being consistent outperformers with unparalleled investment prowess. Since then, many endowments have found stellar outperformance to be elusive. Indeed, a deeper dive into the data suggests many of the more sophisticated (and costly) strategies, often a primary component of endowment allocations, have struggled in recent years. We will discuss the implications this has had on portfolio returns and share our outlook for alternative investments later in this paper.

We base our analysis on the NACUBO-TIAA Study of Endowments® (NTSE), a joint research project of the National Association of College and University Business Officers (NACUBO) and TIAA. The 2018 study included 802 institutions, representing $616.5 billion in endowment assets. Repeat participation is very high for this study: about 94% of study respondents reported in the previous year. This allows for better and more informative year-on-year comparisons. The latest data cover the 2018 fiscal year, July 1, 2017 through June 30, 2018.

Here we expand the analysis we provided in the February 2019 report, *Endowments and Foundations: 2018 in Review*, which was based on preliminary information from the executive summary of the 2018 NTSE. This commentary will cover some of the same information while adding further insights gleaned from the complete NTSE study.

Fiscal 2018 Results

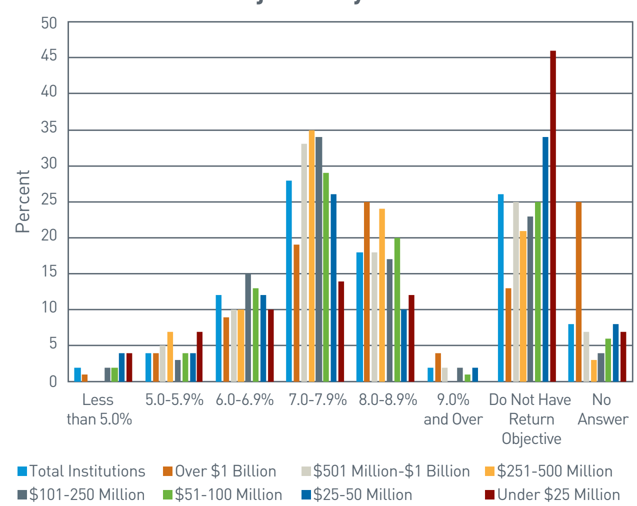
The complete 2018 NTSE study revealed several ongoing trends among the endowments of higher education institutions, some of which we have highlighted previously. New information available from the full report in this section includes:

- relatively high long-term investment objectives;
- little change in fund flows; and
- rise of social restrictions for investing.

Long-Term Investment Objectives

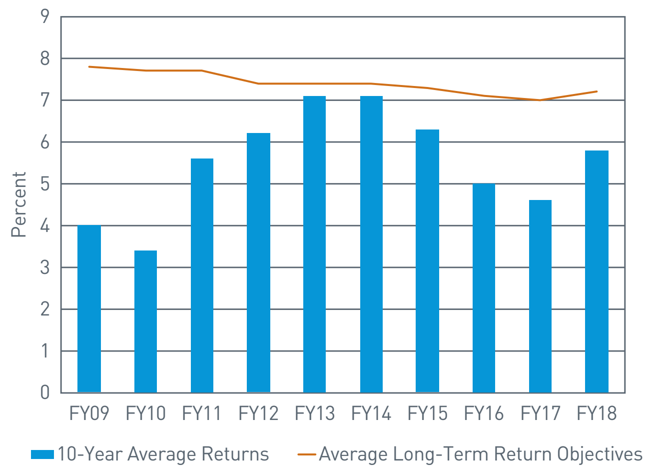
The purpose of an endowment is typically to help support a distribution for a specific purpose, such as academic institutions. Survey respondents cited student financial aid as the greatest purpose of these distributions (49%), with academic programs (16%), endowment faculty positions (10%), operation and maintenance of campus facilities (7%), and "all other purposes" (18%) as the other choices. The investment policy statement or other policies governing the investment program will typically describe the methodology for determining the spending rate/ amount in a given year. This process, in turn, helps determine an investment objective that accounts for the distribution, inflation, and overhead costs without impairing the principal of the assets. In the fiscal 2018 report, investment objectives were reported by size for the first time. The average return objective for all responding institutions was 7.2% and the median was 7.5%. Chart 1 shows the distribution of these return

Chart 1
Investment Return Objective by Size Cohort



Source: NACUBO, PNC

Chart 2
Average Return versus Long-Term Return Objectives



Source: NACUBO, PNC

objectives by size. Perhaps most surprising to us is the large portion of the respondents who did not have a return objective, which we believe is contrary to an investment program's best practices.

While the investment objectives of these programs have remained high, the last decade has not been kind to the average institution, with many struggling to meet these goals. Indeed, over the past 10 fiscal years, the 10-year average return for respondents in the study has consistently fallen short of the long-term objective (orange line in Chart 2), placing an increased focus on generating inflows of gifts to maintain purchasing power. Chart 2 shows the deficit spread between target and realized returns averaging 1.9% over this time period.

Fund Flows

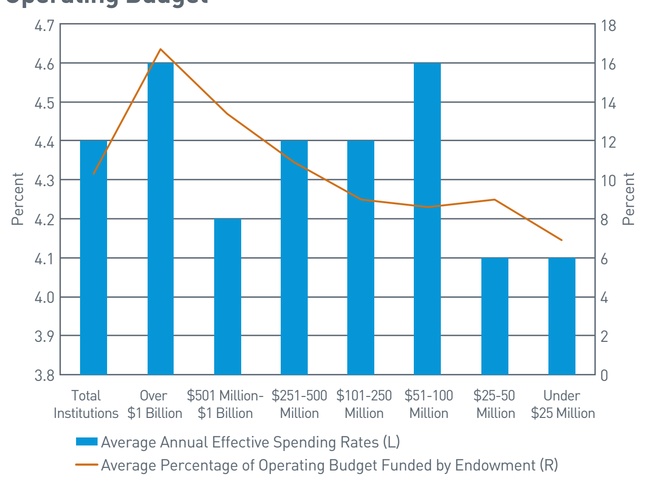
Perhaps in response to the low-return environment, endowment spending rates moderated year over year. The average annual effective spending rate remained steady at 4.4%, largely in line with the 10-year average of 4.38%. The larger endowment cohorts (above $101 million) posted a moderate decrease in their average spending rate of 0.1%, while the smaller endowment cohorts ($100 million and below) posted a moderate increase in their average spending rate of 0.1%. Not surprisingly, effective spending rates are positively correlated with endowment size: the largest endowments generally have the largest spending rates. Chart 3 illustrates the average annual effective spending rates by size cohort relative to the average percentage of the operating budget funded by the endowment. This might help explain why larger institutions, which tend to fund more of their operating budgets from their endowments than smaller institutions, average a higher overall effective spending rate than smaller cohorts.

It is worth noting that there should be a strong negative correlation between the aggregate portfolio risk profile of the endowment and the degree to which the operating budget is dependent on distributions from the endowment. As a general example, institutions for which the distribution is a low percentage of the operating budget might be able to take more equity risk, thus increasing sensitivity to a downturn, whereas an institution for which the distribution is a high percentage of the operating budget might need to take less equity risk to reduce the likelihood of forcing large cuts in the operating budget during a major downturn in the market.

There have been calls in the institutional investment industry over the last couple of years to reduce distribution rates, where possible, in light of muted future return expectations. This year was the first year institutions reported decreasing spending: 58% of institutions reported decreasing spending rates while only 22% increased rates, with the trend in lower spending rates led mostly by larger institutions.

While spending *rates* remained fairly steady on a year-over-year basis, spending in *dollar terms*

Chart 3
Effective Spending Rates versus Percentage of Operating Budget



Source: NACUBO, PNC

increased for 66% of reporting institutions in fiscal 2018 compared to 65% in fiscal 2017. This is likely a function of spending rule-related calculations, in our view. Seventy-five percent of endowments report using a moving average spending rule to calculate spending rates. While this usually tempers immediate spending in a downturn, it can also result in steady increases over a period of positive market returns.

For more information on setting a spending policy for your organization, please see our white paper Spending Policy: Development and Implementation.

Responsible Investing

This year marked an increase in the data available on responsible investing compared to previous NTSE studies. The first is the continued discussion around environmental, social, and governance (ESG) criteria, albeit at a slow trend. In fiscal 2018, just 18% of portfolios maintained some type of ESG screen versus 16% in fiscal 2017. On a similar level, 21% of institutions reported excluding or screening out investments inconsistent with the institution's mission. The study noted that while implementation was still low, more and more institutions are discussing responsible investing at the board level.

At the same time, a small subset of endowments report intentionally *disavowing* ESG considerations. This year, 8% of institutions said their board voted specifically to exclude any responsible investing considerations, rising 1% above its fiscal 2017 level. The most significant reason cited for not pursuing a responsible investing strategy was "potential adverse impacts on investment performance," selected by 58% of respondents. We think this decision may be misguided and more so due to a lack of proper education and guidance around ESG portfolio integration than an immediate performance tradeoff. Nevertheless, each organization's approach is likely to be different and nuanced, so we would prefer to review on a case-by-case basis rather than make broad generalizations.

Despite these trends, we believe more endowments will implement some type of ESG or responsible investing overlay in the coming years, given growing social and environmental awareness among many investors and donors. The most common type of negative screen is applied to tobacco, alcohol, and firearms, which tends to be fairly easy to implement because the universe of companies is small, concentrated, and rather well-defined.

Performance by Endowment Size

Based on data compiled over the past few years, the primary differentiating factor in performance among endowments has been size. On average, large endowments, those with assets exceeding $1 billion, historically have outperformed smaller endowments, namely those with less than $500 million in assets. These largest endowments, which account for about 13% of all endowments tracked in the NTSE report, typically attract the most headlines and scrutiny, resulting in several misconceptions about overall endowment performance.

In general this year, returns were positively correlated with endowment size, with the larger endowments outperforming the smaller ones. However, the difference in overall performance was slightly larger than in recent years. The gap between net returns of the largest endowments in the study (9.7% for endowments with more than $1 billion in assets) and the smallest in the study (7.6% for endowments less than $25 million in assets) was 2.1 percentage points compared to the 1.3-percentage-point gap seen last year (Chart 4).

Chart 4
1-, 3-, 5-, and 10-Year Returns by Endowment Size

Source: NACUBO, PNC

While one-year performance is not insignificant, most endowment managers use a longer-term view for planning purposes. While the largest endowments remain the best performing cohort over longer investment horizons, the relative outperformance varies as the investment period is extended. The three-year spread is 0.6 percentage point, the five-year spread is 0.7 percentage point, and the 10-year differential is just 0.2 percentage point.

Over the majority of timeframes, the best performing cohort was the largest, with an average return of 6.8% over three years, 8.2% over five years, and 6.0% over 10 years. Similar to the prior fiscal year, there was low correlation this year between size and return. Indeed, the smallest endowments were not the worst performers; instead, the medium-sized endowments, that is, those with $25–500 million in assets, had the lowest performance. That S-shaped return curve, where the largest and smallest endowments on average outperformed mid-sized ones, appeared in every return series with the exception of the 10-year, where returns are fairly evenly distributed around the 5.8% average return level.

Regarding that 10-year number, both the largest and smallest cohorts posted the largest average annual returns, between 5.8% and 6.1%. Meanwhile the medium-sized cohorts posted slightly weaker returns.

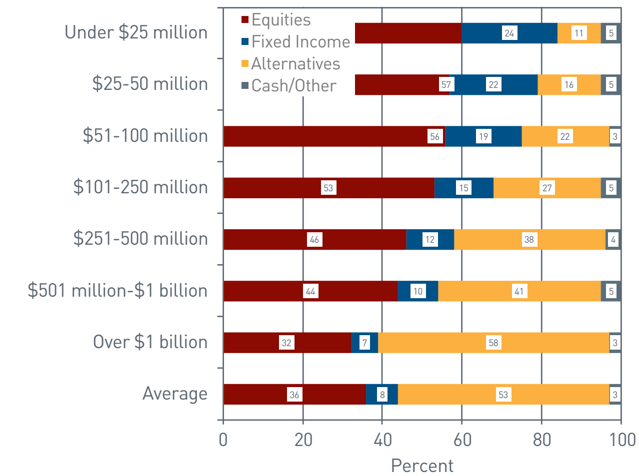
Short- and long-term returns coming in below expectations among all endowments may be a cause for concern, in our view. According to past survey results, many endowments report they require an annual return of 7.2% to maintain their purchasing power after spending, inflation, and investment management costs. The fact that the 10-year average return, described as “mission-critical” by the industry, increased from 4.6% in 2017 to 5.8% in 2018 is promising but nevertheless short of the level that would preserve purchasing power for these pools of assets. These numbers can vary significantly by institution, but we still believe a weaker return stream may make it difficult for many endowments to meet this funding objective.

Asset Allocation by Endowment Size

A more granular look helps decipher how endowments have adjusted their asset allocations based on size. Only firms with assets in excess

Chart 5

Asset Allocation by Endowment Size



Source: NACUBO, PNC

of $1 billion have an above-average allocation to alternatives on a dollar-weighted basis; on an equal-weighted basis, the $251-500 million and $501 million to $1 billion cohorts also have an above-average allocation to alternatives. Hence, the smaller the endowment, the more traditional the asset allocation (Chart 5).

Over the past fiscal year, smaller endowments benefited from their higher allocation to public equities relative to the larger cohorts. For fiscal 2018, domestic equities were the best performing asset classes, with the S&P 500® up more than 14%. Meanwhile, non-U.S. equities were up 7% and fixed income lagged, with the Barclays U.S. Aggregate Bond Index down 0.4%. While performance can vary among active managers, alternative investments experienced a slight pickup in performance, rising from 7.8% in fiscal 2017 to 8.3% in fiscal 2018.

Insight into Fiscal 2019

With fiscal 2019 ended on June 30 (recall that fiscal years run from July 1 through June 30), it is possible to glean a few insights into how these endowment portfolios are likely to fare in the next study.

As we have noted, those endowments with the greatest exposure to equities (both domestic and international) benefited the most over the past few years. Returns are slightly down from prior years, with the S&P 500 up roughly 10.1% from July 1, 2018 to

June 30, 2019. This is down about 4 percentage points from the previous year's comparable period.

The domestic stock market return for fiscal 2019 has been challenged by a downturn from October to December 2018 and again in May 2019. Volatility in the S&P 500 has picked up periodically as global macroeconomic events continue to influence corporate confidence and investor sentiment. In the month of May alone, investors were faced with trade war concerns, a "kinked" yield curve, and debates over peak earnings, among a confluence of other variables. While we still believe the existing tariffs alone are unlikely to cause an imminent global recession, their cumulative impact on corporate confidence could curb net-new capital investment necessary to boost productivity and extend the economic expansion. Combined with persistently below-target inflation, this recent soft-patch could put the Federal Reserve (Fed) in a difficult position. If being patient means being data-dependent, subsequent adjustments to monetary policy may not be as effective as hoped, since the outlook appears to be evolving quickly. Given these headline risks the market continues to wrestle with and depending on the timing of necessary distributions, this could cause some performance challenges for endowments in the short to intermediate term.

Although we continue to see relatively lower earnings multiples in international markets, a number of near-term headwinds are pressuring returns this year, namely:

- trade/protectionism-related concerns;
- a loss of economic momentum in the Eurozone;
- a strengthening dollar;
- a decoupling of monetary policy between the Fed and the rest of the world; and
- the potential for populist outcomes in several countries.

The MSCI World ex. U.S. Index is up 3.8% in fiscal 2019, slightly down compared to the 5.4% posted over the year-earlier period.

Similarly, alternatives are also posting weaker returns compared to previous years. The HFRI Fund of Funds Composite, a proxy for hedge fund investments, is up 0.9% from July 1 through April 30, which is down from last year's 5.0% over the same timeframe. Within the composite, the HFRI Relative Value had strong performance of 3% over the period while the HFRI Market Neutral index lagged on performance of -0.5%.

Though official performance data are not generally immediately available for private equity and real estate at the end of a calendar quarter, some trends did emerge. In private equity, we saw opportunities in new/less efficient markets and a more diverse investable opportunity set, for example, via secondaries and co-investment options and in middle-market buyout strategies. In private real estate, key drivers include a still relatively constrained supply backdrop, modest leverage levels, and capital flows into the asset class that are becoming increasingly global (that is, investor demand is quite robust). In private debt, middle-market lending in the corporate sector is still quite constrained, continuing to create opportunities for many private debt investors. We continue to see investors rewarded with a substantial illiquidity premium for taking on unrated, smaller-sized loans. There is some concern, however, as the Barclays US Agg Credit Corporate High Yield (Caa) index, a public market proxy for private debt performance, delivered a total return of 0.4% across fiscal 2019.

In traditional fixed income, the Bloomberg Barclays U.S. Aggregate Bond Index returned 7.9% in fiscal 2019, significantly above returns in the prior two years. Similarly, the Bloomberg Barclays Corporate High Yield, even with the credit cycle aging, returned 7.7% in fiscal 2019 as investors chased yield; the Bloomberg Barclays Emerging Market, where commodity prices offered a tailwind for net-export countries, returned 11.1% in fiscal 2019.

Reevaluating Allocations and Strategies

Where Do We See the Capital Markets Going?

One of the biggest challenges facing investors today is the possibility of low economic growth and below-average investment returns for most asset classes over the next 10 years. The reality of what we believe to be a lower-return environment has been consistently reflected in our Capital Market Assumptions (CMAs). Our CMAs have been steadily falling over the course of this cycle, but 2018 was the first year we started to see a stabilization of returns in certain asset classes. Our 2019 analysis suggests 2018 may have been the inflection point in returns, although one year does not necessarily make a trend. As we documented last year, 10 years into the economic expansion, valuations are now quite full by most metrics we track, which suggests to us more muted price appreciation in the longer term.

Are equity returns in the 11–13% range considered reasonable, or are 7–8% returns more appropriate? At one time, the higher range was considered a reasonable assumption, at least by historical standards. Not so today, in our view. We think there has been a cyclical shift lower in returns, largely a function of the following items:

- where we currently stand at this stage of the business cycle (later innings);
- sluggish overall economic growth;
- peaking corporate profits and margins; and
- a lack of capital investment activity.

The implications from these views, of course, have had a material impact on how we think about designing portfolios for long-term strategic asset allocation positioning as well as tactical guidance, risk-taking/mitigating exposures, shortfall risks, and so forth.

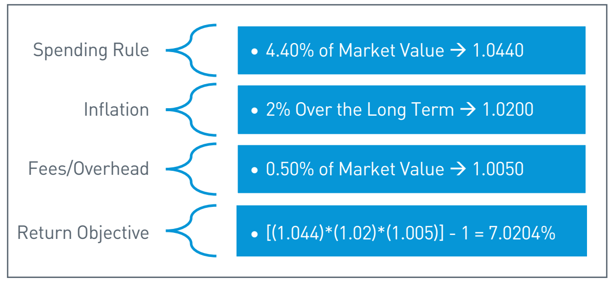
The key consideration is, how long do investment returns remain "under pressure"? Is it a cyclical change (that is, specific to the current business cycle) or more of a secular phenomenon (that is, with lasting, long-term effects)? We used 30-year CMAs for modeling purposes in this analysis to more closely resemble what we believe a typical endowment would likely experience over the course of multiple market cycles. Despite this, we do not see a materially improved returns backdrop over the next 10+ years. This translates into a heightened concern, in our view, regarding potential shortfall risks (that is, the risks that an endowment's returns fail to meet the required spending policy) and the associated implications of having to play catch-up over the remainder of the horizon — a highly undesirable outcome.

Reconciling the Future Outlook with Investment Program Objective(s)

Every endowment must balance multiple and sometimes conflicting goals, including meeting return objectives, limiting undue volatility, managing shortfall risk, and minimizing expenses. It is a tall order, and some endowments appear to be managing these objectives better than others. Returning to

Chart 6

Average Effective Spending Rate



Source: PNC

the objective discussed on page 1, that is, to grow the endowment at least fast enough to maintain or increase distributions while keeping up with inflation, the math implies a 7.02% return necessary to achieve the average effective spending rate from this year's survey, 4.4% (Chart 6).

At a time when the expected return on traditional asset classes is likely to be below historical norms, it has become increasingly important to consider the role of alternatives in investment portfolios. When carefully selected, we believe alternatives have the potential to add incremental return in an otherwise low-return environment, in addition to improving the overall rise profile of portfolios through the diversification benefits offered by certain strategies. Specifically, alternative investments can be an effective means of diversifying risk and ultimately reduce overall portfolio volatility. Given the volatile path of the market to date over the last year, we believe it is especially important to key in on the diversification of risk and volatility mitigation that alternative investments can provide.

When looking at alternative investment performance over the last decade, it is important to remember that active management performance is highly cyclical and alternative investment strategies are the epitome of active management. In the recent (as in, the past several years) market environment of low volatility, high correlation, and low dispersion, active management in general has struggled. Additionally, low interest rates and compression on the cost of capital have made it structurally more challenging for active managers this cycle to earn their fees. With that said, we believe the environment for active managers and alternatives, in general, is beginning to improve.

Regardless, the use of alternative investments requires significant due diligence. Alternatives are often sought for diversification benefits, which could lead to better risk-adjusted returns. However, alternatives tend to be less liquid, charge higher fees, and can be subject to regulatory limitations. While we continue to believe a reasonable allocation to alternatives can add value to the average endowment's portfolio, we nevertheless suggest all endowments should perform extra due diligence when deciding on their allocations.

Key Takeaways

With fiscal 2019 now at a close, most boards and investment committees are looking at fiscal 2020 in the context of their investment program objectives. To continue to meet these objectives in light of a near decade of falling return expectations, we recommend that decision makers consider carefully the right allocation mix to meet their investment goals and objectives while balancing considerations for both short-term volatility and long-term shortfall risk.

Regarding the challenge of liquidity and alternative investments, the PNC Institutional Advisory Solutions® (IAS) Investment Strategy Team has performed extensive simulation analysis based on explicit modeling of the structural characteristics to account for their relatively illiquid characteristics (that is, subscription/redemption periods and capital commitment/drawdown/distribution processes). The analysis showed that with a combined targeted allocation of approximately 20–30% to alternatives, the portfolio is unlikely to experience either explicit liquidity problems or excessive drift in portfolio weights, provided a significant portion of the allocation is directed to funds which allow the investor reasonable control over the timing of investment and redemption (for example, hedge funds, which tend to be relatively more liquid). However, the risk of such problems rises rapidly with larger allocations.

Additionally, we believe the traditional/balanced asset allocation approach (60% stock/40% bond) is not sufficient to address the specific challenges facing endowments regarding liquidity needs, spending levels, and fairly high required rates of return necessary to achieve these objectives. With this as the backdrop, the IAS Investment Strategy Team has done comprehensive analysis to design and develop customized asset allocation frameworks (including and excluding allocations to alternatives) specifically for endowments. Indeed, we think they are effective solutions capable of meeting or even exceeding a typical endowment's long-run spending and return objectives with the potential to actually grow real wealth and distributions over a 30-year investment horizon.

For more information about our approach, please contact your PNC Investment Advisor.

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For definitions of indexes used in this publication, please refer to pnc.com/indexdefinitions.