Shelter From the Storm

The decade ahead is certainly going to look very different from the previous 10 years for endowments and foundations, in particular higher-ed institutions. Faced with lower expected investment returns, rising inflation, pressure on spending rates, and net-tuition revenue, colleges and universities will need to consider the endowment's role in sustaining the enterprise and how best to position it to preserve and grow intergenerational equity entrusted to the school.

While I confess the following analogy might be a bit of a stretch, recent market volatility and apparent lack of safe harbor have had lyrical poet Bob Dylan's *Shelter From the Storm* playing on a loop in my mind. Off the 1975 release *Blood on the Tracks*, widely considered one of the greatest albums of all time (and I agree), I am particularly taken by the third stanza. When listening to or reading the verse through the lens of asset markets over the last decade, it appears to juxtapose the sentiment of one-way equity returns against institutional investors running for the exits in search of safety in early 2022.

> *Not a word was spoke between us, there was little risk involved*
> *Everything up to that point had been left unresolved*
> *Try imagining a place where it's always safe and warm*
> *Come in, she said*
> *I'll give ya shelter from the storm*[1]

It would be remiss, of course, to suggest "*there was little risk involved*" in equity investing over the last decade, particularly as markets plumbed depths in March of 2020 as the pandemic took hold. However, the rebound was swift, supported by tepid inflation, accommodative monetary policy, and a pivot toward growth, rewarding the traditional 60/40 investor with 9.1%[2] real returns between 2011-2021. 9.1% certainly pales in the context of average higher-ed endowment returns of 30.6% (FY2021) as reported by NACUBO[3] , but my guess is that in the face of fiscal challenges ahead for higher-ed, most investment committees would sign up for that in a heartbeat if it were on offer! Regrettably, though, it is not on offer, and similar expected returns are likely aspirational in the years to come.

Ron Popeil was the founder of Ronco and an early pioneer of the infomercial. While hawking his revolutionary Showtime Rotisserie & BBQ between late-night reruns, his catchphrase was "set it and forget it!" The simple concept was that the Showtime would do all the heavy lifting and produce a delicious meal with limited input from the chef. Much the same could be said about the traditional 60/40 asset allocation, which served many institutions well for years, particularly smaller endowments with limited or no access to higher octane private assets. For over the past 20 years, traditional equity offered growth and generally was negatively correlated to fixed income providing ballast in down markets and easy access to liquidity. All was well in the world. Set it and forget it.

Enter 2022, which has brought about a sharp uptick in market volatility, rampant inflation eroding purchasing power, negative real rates of return on core fixed income, and crucially, a breakdown in the

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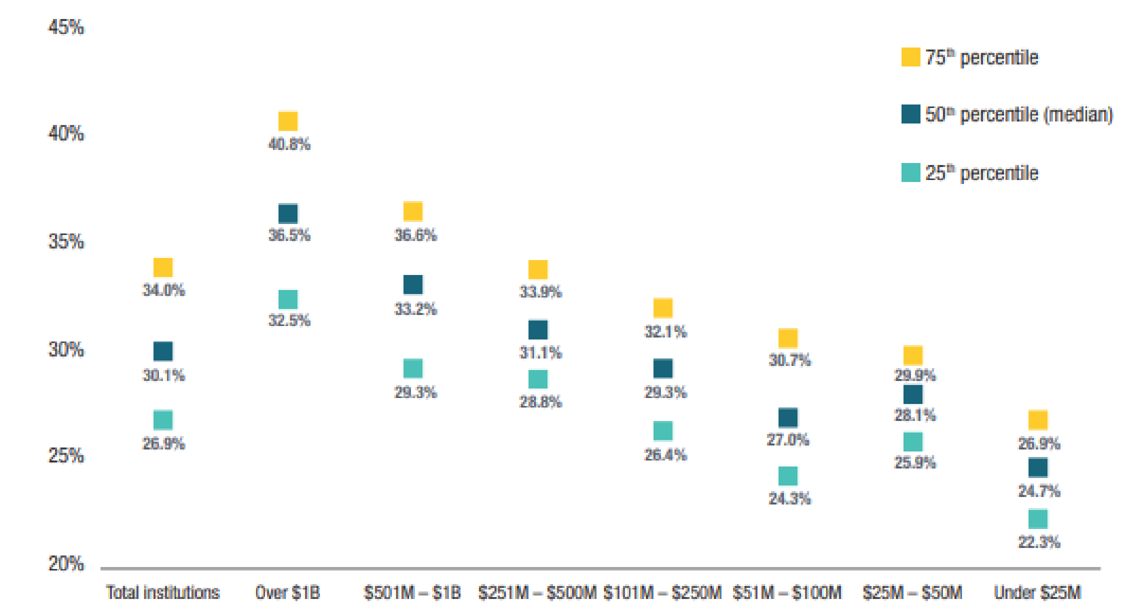
[1] Shelter from the Storm lyrics © Universal Music Publishing Group
[2] Is the 60/40 Dead? GSAM 10/15/21
[3] 2021 NACUBO-TIAA Study of Endowments, Average FY21 return of 720 institutions surveyed

negative correlation between equity and fixed income. In other words, no ballast, no shelter from the storm. A recent report published by AQR projected a Global 60/40 portfolio to generate a real return of 1.9%[4] per annum over the medium term, down from 2.1%. This is a far cry from the 9.1% enjoyed in the previous decade and presents a mathematical conundrum for schools modeling a 4.5-4.7%[5] spend on historically expected return targets of roughly 7-8%. Quick, back of the envelope sums don't take long to confirm the risk of eroding the corpus and a potentially negative impact on mission. Absent significant annual fundraising to fill the gap, access to "alpha" or excess returns will be the primary driver enabling institutions to navigate the current environment and improve the probability of getting closer to return targets. However, the challenge at this point is that all endowments are not created equally, nor do they have equal access to the primary drivers of excess returns.

The takeaway from the following two tables is stark and clearly illustrates the impact access, or lack thereof, to sources of excess return can have on returns. While median FY21 returns for endowments <$250M were indeed impressive, ranging between 24.7% & 29.3%, those returns lagged their larger brethren in some cases by hundreds of basis points, with median returns for endowment pools >$500M falling between 33.2%-36.5%. Those basis points have real impact as they tie back directly to scholarships, research, and operations.

Dispersion of one-year returns, FY2021

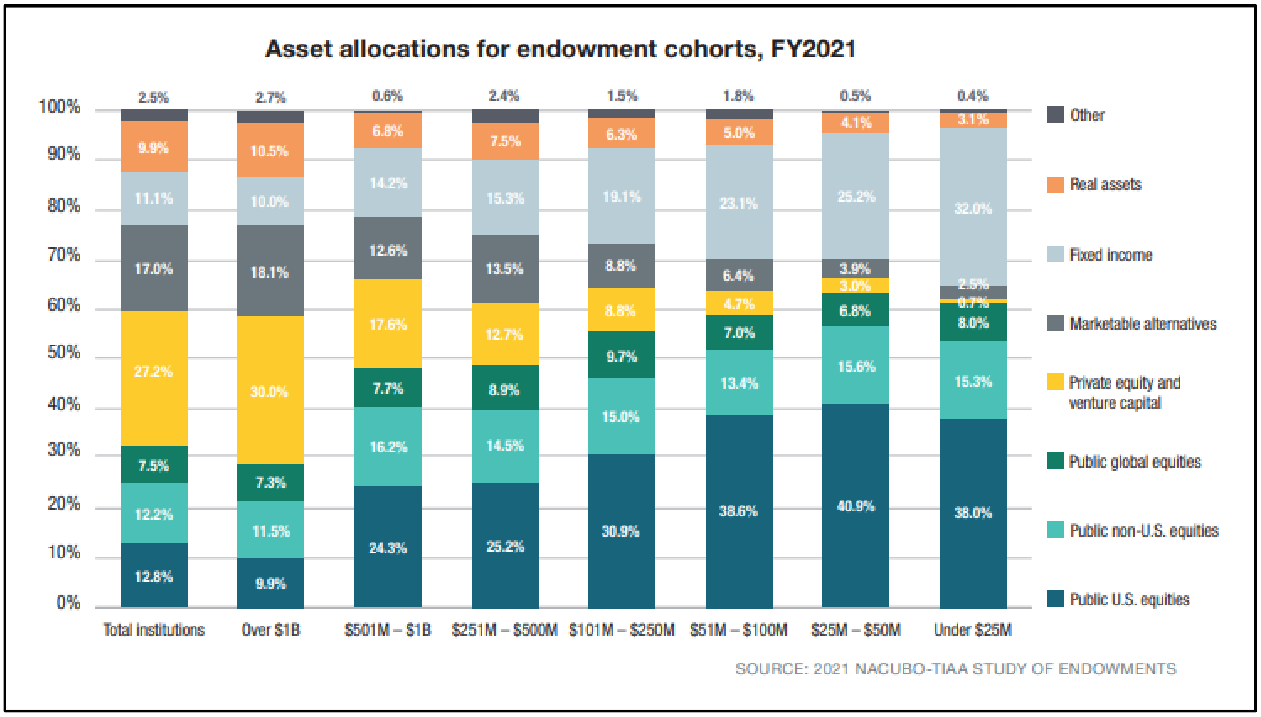


SOURCE: 2021 NACUBO-TIAA STUDY OF ENDOWMENTS

As the following table illustrates, the sharp differences in returns can, to a large degree, be directly attributed to asset allocation and in particular private assets. As you will note, smaller endowments <$500M generally have larger allocations to public equities (US/Non-US) and fixed income with limited

[4] AQR Capital Market Assumptions for Major Asset Classes, Q1 2022, "medium term" defined as 5-10 years
[5] 2021 NACUBO-TIAA Study on Endowments Average Annual, Effective Spending rates $51M->$1 billion

exposure to private equity, venture capital, and other marketable alternatives relative to their larger peers. According to a report published by NEPC in January 2022 discussing performance attribution for larger endowments, "*higher allocations coupled with the exceptional performance of private venture capital (+86.6%) and private equity (+55.1%) make it is easy to understand why the mega endowments sailed past their smaller peers in 2021.*"[6]



In 1974 American Economist and Nobel Laureate James Tobin wrote, "*The trustees of endowed institutions are guardians of the future against the claims of the present. Their task in managing the endowment is to preserve equity among generations.*" At Angeles, we agree with that sentiment and recognize we are indeed in the midst of a storm. A storm that may challenge the role of endowments and have collateral impact on financial sustainability across higher-ed in the years ahead. In the spirit of good governance, we suggest the following questions should be top of mind as college and university presidents, administrations, and trustees navigate the road ahead.

- What percentage of annual operations is the endowment projected to fund over the next five years? Has that percentage trended up or down in recent years?
- How is the institution approaching preservation/growth of intergenerational equity given declines in expected investment returns?
- In what ways might pressure on net tuition revenue and changing student demographics impact reliance on the endowment?

[6] Mega Returns for Mega Endowments in 2021, January 19, 2022 NEPC

- How does the endowment asset allocation consider non-endowment, enterprise assets and liabilities, and potential capital campaigns?

At Angeles, we believe colleges and universities can find shelter from the storm. It begins with discovery, discussion, and mapping the unique needs and sensitivities of institutions to an asset allocation which enhances the probability of preserving intergenerational equity while providing present-day liquidity to meet current needs.

For smaller institutions, we believe this can be achieved by bifurcating exposure into two primary categories, *Growth* and *Liquidity*. At a very high level, while not abandoning public equity, the Growth category will pivot toward a greater reliance on private assets, which offers the opportunity to capture an illiquidity premium not available in public markets. This part of the portfolio will be focused on equity and equity-like assets that will provide the engine for excess returns. Liquidity is just that, highly liquid assets held in cash or cash equivalents to ensure an appropriate amount of liquidity is available to fund predetermined liquidity needs (e.g., annual spend for 1 or 2 years or what is deemed prudent.)

Clearly, this topic, this challenge, and available solutions demand vastly more discovery and discussion than the preceding 1305 words can offer. Still, it remains a critical and timely conversation and one that will indeed assist colleges and universities to plot the course ahead.

Take us out Bob………….

Suddenly I turned around, and she was standin' there
With silver bracelets on her wrists and flowers in her hair
She walked up to me so gracefully and took my crown of thorns
Come in, she said
I'll give ya shelter from the storm[7]

Garry Duncan, Managing Director

Angeles Investments

[7] Shelter from the Storm lyrics © Universal Music Publishing Group