New strategies for endowment and foundation investing

How managers are adapting to the challenges of today's markets

GLOBAL INSTITUTIONAL CONSULTING

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"This time, like all times, is a good time, if we but know what to do with it." — Ralph Waldo Emerson

Managing any investment portfolio in today's volatile, low-return financial markets is a formidable challenge. Even more so for endowments and foundations whose investment results directly affect their ability to deliver on their missions to improve education, health, community services or the environment.

As managers of endowments and foundations seek new growth in difficult domestic markets and a sluggish worldwide economy, the additional funding they may receive from donors is also less predictable. That puts extra pressure on these managers to implement strategies that can grow their portfolios without taking on more risk than is necessary. But what are those strategies and how are these organizations using them? In this report we offer insights into how endowment and foundation managers are adapting to the challenges of today's financial markets.

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What's keeping endowment and foundation CIOs awake at night?

This was the question that the Global Institutional Consulting (GIC) team at Bank of America Merrill Lynch sought to answer when we asked the Spectrem Group to explore how the managers of endowments and foundations are responding to today's investment challenges. In the last half of 2012, senior Spectrem consultants interviewed the investment managers or chief investment officers (CIOs) at more than two dozen endowments and foundations to get a more complete picture of their investment strategies and ongoing concerns. Their findings are summarized here, along with some of the candid, verbatim comments from the managers they interviewed.

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We've also included our own observations to provide additional insight on the three key trends that emerged from the research. Trends noted in the study are:

- **A continuing shift in asset allocation strategies** away from traditional equity and fixed income investments to alternative strategies to try to manage volatility and interest rate risk
- **Increased attention to investment manager selection and oversight,** as wholesale changes have been made to manager lineups to support alternative strategies
- **An emphasis on investments that can provide hedges against inflation risk** to position portfolios for what may lie ahead

Top investment challenges for endowment and foundation managers

When we asked endowment and foundation managers which investment challenges they considered to be most critical, **asset allocation** decisions appeared at the top of the list, followed by concerns about **due diligence** and **inflation hedging**. Here's a closer look at what they said about each of these challenges.

TOP INVESTMENT CHALLENGES

1 **Asset allocation**[1]**:** Finding the optimal combination of returns, risk and liquidity

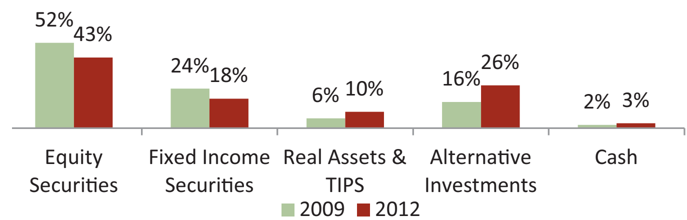
Establishing the right mix of investments to overcome a lackluster, but often volatile, market without taking inordinate risk or losing flexibility was the primary challenge for the investment managers and investment committees at foundation and endowments during this period.

The return of their portfolios to pre-recession asset levels by mid-2012 suggests that the new strategies they implemented over the past three years were effective in getting them there. Those strategies included:

- Reducing the allocation to and/or shortening the duration of fixed income portfolios to stay flexible and limit losses if interest rates rise
- Increasing the allocation to alternative investment categories — in particular, private equity and long/short funds to mitigate volatility and reduce downside risk
- Adding or increasing real assets (commodities and real estate) and/or Treasury Inflation-Protected Securities (TIPS) to hedge against inflation

On average, the organizations we spoke with reduced their allocations to public equity and fixed income categories (from 76% to 61%) and increased their allocations to real assets and alternatives (from 22% to 36%) over the past three years.[2]

Exhibit 1. Asset allocation changes since 2009



> "We have become more focused on income rather than capital gains. We've added REITS, preferred stock and an equity covered-call manager."
> *($70 million private foundation)*

In fact, the CIOs and investment managers who had made significant changes to their allocations since 2009 did so for a variety of reasons, as outlined in the table in Exhibit 2 on the next page.

Because portfolio allocations must respond appropriately to shifts in the economy and the markets without overreacting to short-term events, today's endowment and foundation manager must continue to take a flexible approach to investing that is backed by a solid Investment Policy Statement with guidelines for investment selection and risk management.

Also, because shifting too much away from fixed income assets can introduce additional volatility risk into a portfolio, we recommend that institutional investors use a multi-asset class approach to income investing — with a risk management overlay. This gives them the flexibility they need to match their income needs while diversifying risk. (See box on the next page.)

[1] Asset allocation does not ensure a profit nor does it guarantee against loss.
[2] Source: Spectrem Group, The Endowment & Foundation Market, 2009.

While larger endowments and foundations with secure donor bases have always used alternative strategies to some extent to help manage risk, smaller organizations have been increasing their allocations to alternatives as well. The more detailed information in Exhibit 3 shows how asset allocation varied by organization size. The growing use of real assets and TIPS as inflation hedges cut across all organizations, regardless of their asset size.

Structuring portfolios for more income and less downside risk

The investment professionals from Bank of America Merrill Lynch's Investment Management and Guidance Group (IMG) recommend a multi-asset class approach to income investing with a risk management overlay. This can provide institutional investment managers with the flexibility and liquidity they need while they diversify risk. The IMG model portfolios feature:

- Multiple asset classes/sectors and multiple investment managers/vehicles to achieve **broad diversification of income sources**. The portfolios consider not only a broad range of dividend-paying domestic or international stocks, but also specific sectors and asset classes that have the ability to generate income.
- **A downside risk management overlay** to mitigate losses in down markets and enhance stability of invested capital.

  Our Downside Risk Management (DRM) strategy seeks to keep the NAV of a portfolio above a fixed floor by moving away from equities or lower quality fixed income securities and into higher quality short duration fixed income and cash in down markets. When the market begins to move up again, this strategy will cycle investments back into the riskier assets.
- **Strategies to enable capital appreciation and income growth.**

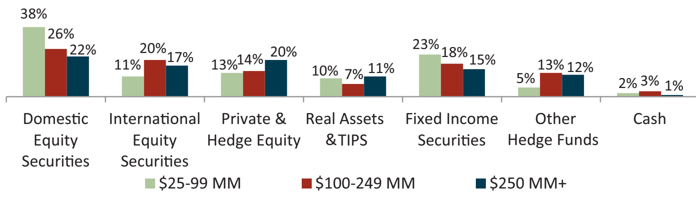
  Including dividend-focused equities in an income solution has become a popular way to pursue greater capital appreciation potential and income growth. But a downside risk management strategy must also be in place to defray the higher risks of equity investments. In addition to dividend-paying equities, investors should consider adding inflation-linked fixed income securities to their portfolios.

For more information on IMG's framework for income portfolios and their proprietary DRM approach, see the Income Solutions Framework white paper, available from your Global Institutional Consultant.

Exhibit 2. Asset allocation strategies recently used by foundations and endowments

Intended outcomes	Portfolio actions since 2009
▪ Stay flexible to meet new developments ▪ Reduce exposure to risk assets generally in risk-off environments ▪ Limit potential losses if and when interest rates rise	Reduced allocation to fixed income and/or shortened the duration of the portfolios
▪ Reduce exposure to risk assets generally in risk-off environments ▪ Manage volatility and downside risk	Reduced allocation to domestic equities
▪ Seek incremental returns by locating assets in faster growing economies ▪ Manage volatility	Increased allocation to emerging markets
▪ Hedge against an increase in inflation ▪ Provide positive return expectations during times of aggressive central bank balance sheet expansion and currency devaluation	Increased allocation to real assets (commodities, real estate, etc.) and/or TIPS
▪ Manage volatility and downside risk ▪ Seek incremental returns	Increased allocation to equity alternative products such as private equity and long/short funds
▪ Avoid leveraged investments and attendant risks in risk-off environments	Decreased allocation to absolute return
▪ Increase expected returns in anticipation of recovery or stabilizing macroeconomic environment through access to higher yielding debt instruments at attractive prices	Added a distressed debt hedge fund

Exhibit 3. Asset allocation by organization size



The larger foundations we spoke with were more likely to use less liquid private equity and hedge strategies, while the smaller ones leaned toward more traditional asset allocation models with a high percentage of public equity and fixed income securities. The smaller foundations and endowments were also more cautious about international equities.

But is this caution justified? To some extent, yes.

The importance of international exposure

A decision to invest in international equities and foreign bonds requires investors to begin thinking about currency fluctuations and exchange rates. So care must be taken to do the appropriate research.

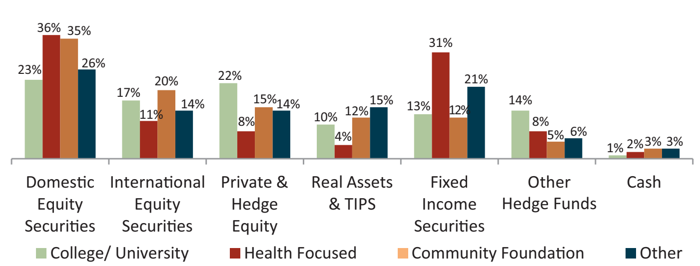
But the shift to more international exposure makes great sense in today's challenging global economy. The bonds of emerging-market governments and companies in places like Malaysia or Indonesia or Peru, for example, have the potential to deliver significant income. As capital flows into those countries and their central banks to lift the purchasing power of their citizens, their currencies will likely appreciate along with investment returns.

A smart, global approach to income investing means working with managers experienced in foreign markets, whether they're watching emerging markets or focusing on more established models of fiscal health such as those in the Pacific Rim and South America.

Asset allocation variations by type of organization

The asset allocation strategies for the endowment and foundation managers we surveyed also varied widely by industry/organization type. Endowment funds associated with colleges and universities (which tend to be larger organizations) used more equity-focused alternatives. Health-focused foundations were less likely to move away from traditional asset categories, with higher allocations to fixed income. In part, this may be because of their more immediate and ongoing income needs.

Exhibit 4. Asset allocation by type of organization



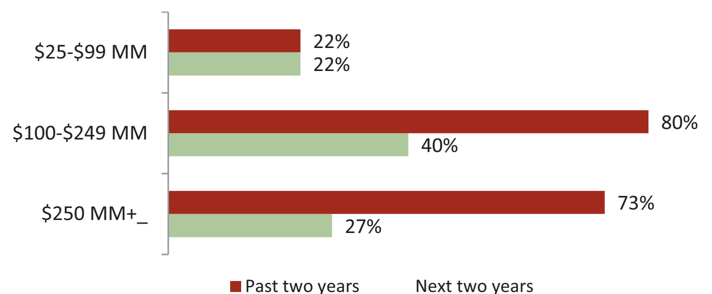
TOP INVESTMENT CHALLENGES

2 **Due diligence:** Identifying and evaluating managers to implement the new strategies

Given the considerable increase in the use of alternative investments such as real assets, private equities and hedge funds (in addition to international securities), it's not surprising that the managers of endowments and foundations named proper due diligence in the selection of managers as the second most important investment challenge for their complex portfolios.

Adopting new approaches to asset allocation has triggered significant changes in the number and mix of investment managers that endowments and foundations use. On average, more than half of the CIOs and managers we interviewed said they had added or replaced managers over the past two years; more than a third expect to make additional changes in 2013.

Exhibit 5. Added or replaced one or more investment managers



As a result of manager changes and additions, these organizations now use an average of 31 investment managers to implement their strategies, up from an average of 21.4 in

[2] Source: Spectrem Group, *The Endowment & Foundation Market, 2009*.

2009.[2] For organizations with assets under $250 million, the greater use of alternatives, especially private equity, has driven the increase. For the largest foundations and endowments, the number of managers has leveled off as their early adoption of alternative investment strategies is largely complete.

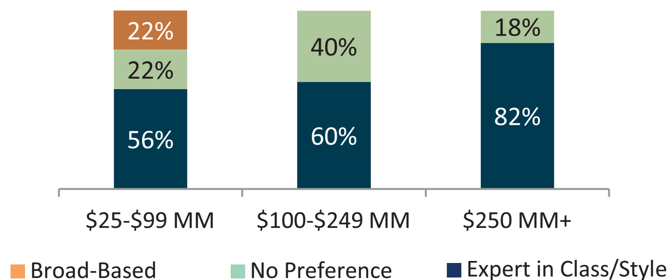
The key criteria the endowment managers (and their consultants) use to evaluate potential portfolio managers are shown in the following chart. High on the list are tenure/stability, long-term performance record, and the transparency of their investment selection process.

In a nutshell: The CIOs and investment committees want to know what they are buying when they choose a manager or strategy, and how the manager intends to deliver results.

Exhibit 6. Importance of factors in manager selection

Most organizations also prefer specialist managers to broad-based ones. They identify managers for particular assignments and want the best in that category. This preference for specialist managers is greatest for larger organizations.

Exhibit 7. Preference for specific types of investment managers



Attention to manager selection criteria

Among the criteria that the IMG due diligence team considers when trying to separate the best portfolio managers from the rest of the pack are:

- **Tenure and expertise**
  Is the manager truly qualified for his or her current role? Just as the global economy favors large, multinational stocks, it also favors managers with proven global reach and experience. So only the largest, most experienced global fund managers hold "Qualified Foreign Institutional Investors (QFII)" status, which is crucial for gaining access to certain international investing markets and Chinese investments.
- **A solid track record**
  Has the manager been tested in good times and bad? Long track records make it easier to discern the lucky from the good, and to see which managers have performed well during the toughest times. As every investor knows, "past returns are not indicative of future results," but they can be a good clue to the disciplines and controls that a manager has in place.

  IMG's due diligence professionals spend considerable energy each year trying to reduce risk by confirming that the approaches used by the funds and managers they select for their platform are backed by consistent patterns of decision-making.
- **Research support**
  Knowing the resources a fund manager commits to in-depth, local and original investment research can help you determine whether the manager can generate original, exciting ideas or will simply follow popular trends.

  In the same way that an innovative manufacturer keeps improving products through research and development, a leading investment manager must maintain a dedicated staff to track events as they unfold and find opportunities that others may miss.

New demands on consultants

Because selecting highly specialized portfolio managers can be particularly challenging, many endowment and foundation CIOs and investment committees are relying more heavily than ever before on their outside consultants for in-depth manager analysis. They are asking these consultants to help them evaluate alternative investment strategies and fully understand the techniques that the managers will use to meet their objectives.

> "We looked for an independent firm with a well reasoned philosophy, transparent processes and a strong record with other clients."
> *($700 million university endowment)*

As a result, some endowments reported using two consulting firms: one firm for assistance with asset allocation studies and manager searches; the other for assistance with due diligence for hedge funds and specialized research.

Overall, the CIOs we spoke with were satisfied with the performance of their outside consultants and gave them high ratings. The average mean tenure of consultants was a little over eight years, with annual turnover of about 10% to 15%. But more than 25% of the CIOs interviewed also reported changing their consultants within the past three years.

The recent moves to new consulting firms were triggered by a number of factors. Among them: the endowment managers' desire for a firm that has more expertise in certain alternative investments, or an expectation that the new consultant would take on more of a due diligence or fiduciary role.

Whatever the reasons for searching out new relationships, the endowment and foundation managers and CIOs we spoke with said it's important for the consulting firm to demonstrate objectivity and transparency, and have a well-defined process in place for manager/vehicle selection.

The consultant's ability to develop a productive working relationship with the foundation's investment committee carried considerable weight as well.

TOP INVESTMENT CHALLENGES

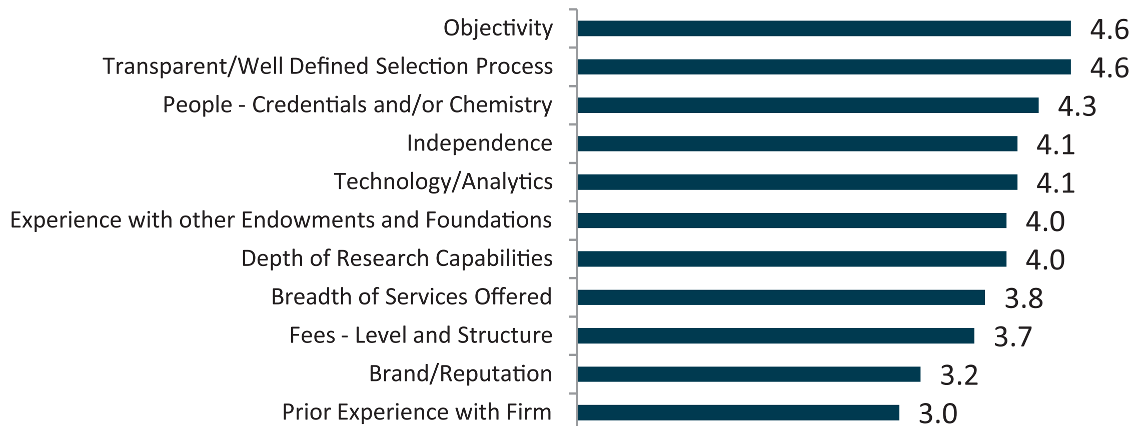
3 **Inflation hedging:** Positioning portfolios for the anticipated increase in interest rates

The third key issue that endowment and foundation managers identified was the need to account for inflation. Most of the managers we interviewed believe that, while still very low today, inflation will come eventually — and suddenly — bringing with it rising interest rates.

> "Our objectives are stated as after inflation. We have added TIPS and increased our allocation to real assets over the past year. We are comfortable that we can deal with it if it comes."
> *($84 million community foundation)*

Their growing concern about inflation has triggered a gradual move to real assets (including real estate and commodities) that are not highly correlated with their core equity and fixed income allocations, and to TIPS.

Exhibit 8. Importance of criteria in selection of a consultant (mean rating on a 5-point scale)



While commodities were just one of the real asset categories cited by the managers as inflation hedges, they may deserve more attention in that role. In fact, commodities provide one of the best natural counterbalances during periods when inflation erodes the value of a bond portfolio or diminishes corporate earnings by driving up the cost of manufacturing.

Because inflation is tied more closely to the rising cost of materials than it is to higher wages or other elements of a faster-growing economy, the hedging power of commodities has historically been strongest when weak growth and high unemployment in the U.S. helped keep inflation at bay. In today's economic environment, where we are faced with similar circumstances, owning commodities may offer an excellent hedge for inflation once again.

For organizations that prefer to hedge inflation without sacrificing liquidity, a real asset portfolio or real estate investment trust (REIT) mutual fund or exchange traded fund (ETF) may also be appropriate.

The value of a well-designed and well executed IPS

As endowment and foundation managers adjusted their tactics to meet the investment challenges outlined above, they continued to rely on their documented investment policies to keep their decisions consistent and on track.

Each of the organizations we interviewed had a written Investment Policy Statement (IPS) in place. Many reviewed the asset allocation guidelines established by their IPS on a regular, annual basis. Others had conducted complete reassessments of their policy statements when they adopted new CIO models of operation or hired new consultant groups.

These findings closely follow Bank of America Merrill Lynch's suggested best practices for developing and maintaining an IPS. Those practices encourage a review of the document at least once a year, with a full-scale reevaluation whenever the organization's investment governance or philosophy changes.

Forces shaping their decisions going forward

For most of the CIOs in the study, "long term" appeared to be measured in years rather than in decades. Their focus is on what may occur in the next two or three years, rather than on longer-term trends. As a result, they see market volatility, inflation, and sovereign and domestic debt as the forces that will continue to shape their asset allocation and investment decisions going forward.

1. Continued market volatility

Assuming that the volatility that characterized investment markets recently will persist, endowment and foundation managers say they are likely to continue their focus on reducing fixed income allocations (particularly Treasury securities) and the duration of fixed income portfolios, and increasing private equity allocations and long/short strategies for public equities to mitigate volatility risk.

> "Our committee feels that volatility is here for the foreseeable future. They're struggling with how to get more alpha without too much [risk]."
>
> *($370 million university endowment)*

Even if changes are not being made immediately, the executives in the study said that their investment committees are spending considerable time discussing

A strategic roadmap for investment management

Trying to achieve an organization's investment goals will continue to be challenging in the years ahead. But the chances of success are far greater with a structured, but flexible, approach to investing that is guided by a well-conceived and well-executed IPS.

The experts at Bank of America Merrill Lynch believe that the IPS is the most important step in the investment process because it:

- Serves as the strategic road map for the prudent management of assets.
- Defines clear objectives and expectations for all parties.
- Creates an essential framework for managing fiduciary risk.
- Becomes a living document that must be evaluated periodically as the portfolio and organization evolve.

ways to manage volatility risks. They are also concerned about the illiquidity of the real assets and private equity securities they hold and the risks this might represent if the market drops precipitously and/or interest rates rise.

2. Looming inflation

All of the CIOs agreed that the monetary policies of the last four years will inevitably result in higher interest rates and inflation at some point in the future. Although they believe that interest rates will remain low for now, they are increasing their allocations to real estate, commodities and TIPS to build an inflation hedge.

> "There is no problem [with inflation] near term but we are looking at a number of possible ways to hedge against it. We do expect it sometime in the future. The question is when."
> *($330 million university endowment)*

3. U.S debt and the economy

While the U.S. debt situation is causing less concern than the possibility of market volatility and/or inflation, it's also inexorably linked to those two topics: That is, when there finally is a political resolution of the debt issue and the economy begins to improve, interest rates are likely to rise, setting inflation in motion and unsettling financial markets. All the more reason why CIOs working with endowments and foundations should be keeping an eye on developments in Washington.

Looking at more immediate issues, endowment and foundation managers say they remain concerned that political leaders in the U.S. have been unable to step up and find solutions to the country's monetary woes. The recent political posturing around the 2012 year-end "fiscal cliff" is just one example of the many fiscal dilemmas they believe could send the U.S economy reeling and corporate profits declining once more.

Managers are also worried about their inability to earn anything near historic rates of return. If things don't improve, this ultimately affects their ability to support the causes for which they were founded.

4. The financial crisis in Europe

The CIOs at endowments and foundations have been monitoring the sovereign debt crisis and other financial woes of the Eurozone with their investment committees. Yet only a handful say that they have taken deliberate action — such as adding distressed debt hedge funds or eliminating international bond funds — to address these issues. Others say that they are prepared to take advantage of any opportunities they discover, but none have been found to date.

> "In 2009 we eliminated a portion of our allocation to international equities and put that money into a European distressed debt hedge fund. That has worked well for us."
> *($725 million university endowment)*

Looking ahead

The CIOs and managers we listened to are taking thoughtful — and so far successful — steps to assure that their endowments and foundations deliver on their missions for the short-term. But the challenge they face going forward is to develop a long-term investment strategy that can withstand the periodic episodes of extreme volatility and unexpected crises that are likely to dominate financial markets for decades to come.

Instead of thinking of market turmoil as a temporary situation to be endured before the return of a calmer "normal," they must adjust to the reality that the world is more turbulent, and that it will almost certainly stay that way. In this new world, it will be critically important to remain logical, measured and thoughtful and not to let emotions intervene.

In fact, the biggest risk for any investor today may not be market drops and the possibility of suffering losses. According to Meir Statman, the economist and expert in behavioral finance, thinking about risk only in literal terms — as the possibility of suffering losses — is a limited view. The bigger risk he says, is to find yourself locked into a position that makes it impossible to achieve your goals.[3]

[3] Meir Statman, What Investors Really Want, McGraw-Hill, 2010.

Traditional modes of thinking now require reconsideration and dramatic shifts in perspective.

For the managers of endowments and foundations, this means:

- **Creating and executing a thoughtful, well-conceived Investment Policy Statement (IPS)** to pursue a structured but still flexible approach to investing.
- **Incorporating risk management into every investment decision,** giving it as least as much thought as efforts to maximize returns.
- **Looking at traditional asset classes through a more global, dynamic prism,** because diversification can no longer be achieved by fulfilling neatly defined asset allocation models with 60% stocks, 30% bonds and 10% cash and then letting them be. Are those stocks positioned to capture global growth, to help protect against currency fluctuations, to provide yield potential? Are you prepared to change directions as new opportunities arise?
- **Including more alternative investments and asset classes, with the appropriate risk controls in place.** Commodities, hedge funds and private equity all may be appropriate for a portion of your portfolio — as long as their risks are mitigated by other strategies.
- **Seeking out asset managers that have broader mandates,** with an ability to hedge positions or to range across borders and asset classes.
- **Diversifying between countries and their regions.** Choosing to invest in Southeast Asian chip manufacturers or South American miners, for example, will become increasingly easy and commonplace.

By adopting an approach that is dynamic, tactical, flexible and quicker to respond than ever before, the investment professionals who manage endowments and foundation assets will be well prepared for whatever lies ahead.

Our commitment in endowment and foundation services

As one of the nation's largest corporate foundations, Bank of America Merrill Lynch possesses the strength and mind-set to support nonprofit organizations in their efforts to champion change. Our deep experience in managing endowment, foundation and donor advised funds is rooted in an investment heritage that dates to the 1900s. Drawing from the strength of our research capabilities and a global open architecture platform, our seasoned investment and fiduciary specialists are focused on providing nonprofits with comprehensive choice and service. This commitment means delivering fully customized investment strategies and solutions capable of fulfilling your organization's mission, investment policy guidelines and liquidity needs.

Study methodology: The results reported here are based on in-depth phone interviews conducted by Spectrem Group in August 2012 with the chief investment officers (CIOs) at 25 endowments and foundations across the U.S. with assets ranging from $30 million to $3.5 billion. The CIOs were randomly recruited from lists obtained from the S&P Money Market Directory and the Foundation Center, and the sample was divided into three segments to ensure representation from organizations of all sizes: 9 had assets under $100 million; 7 had assets between $100 and $250 million; and 9 had assets of $250 million or more. The sample also represented organizations with different missions. Forty-four percent were college/university endowments, and the others were equally divided among health focused private foundations, community foundations and other groups. The average interview lasted 40 minutes, and both qualitative data and verbatim comments were gathered.

Data source for all charts: Bank of America Merrill Lynch Endowment & Foundation Study, 2012.

Diversification cannot ensure a profit nor does it guarantee against loss.

Investing in securities involves risks, and there is always the potential of losing money when you invest in securities.

Economic or financial forecasts are inherently limited and should not be relied on as an indicator of future investment performance.

Alternative investments are intended for qualified and suitable investors only. Alternative Investments such as derivatives, hedge funds, private equity funds, and funds of funds can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity, and your tolerance for risk. Alternative Investments are speculative and involve a high degree of risk. An investment in alternative investments is not suitable or desirable for all investors. Investors may lose all or a portion of the capital invested.

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