STRATEGIC ASSET ALLOCATION FOR ENDOWMENTS AND FOUNDATIONS — 2015–2016

It's About Implementation

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Endowments and foundations typically target returns sufficient to maintain purchasing power while supporting significant ongoing distributions. High target-return portfolios are necessarily equity-oriented. But after an extended period of strong returns (particularly in the U.S. market), we expect equity returns over the next several years to be more modest. For example, Northern Trust's Capital Markets Assumptions (CMA) Working Group estimates in its Five-Year Outlook: 2015 Edition that annualized index level returns over the next five years for global public equity will be only 6.5%. Bond market yields also are expected to stay low, with the CMA forecasting investment-grade bonds will return 2.5% annually during the next five years. These projections mean high target-return investors are focusing more than ever on ways to implement strategies supporting their portfolio objectives.

PARAMETERS AND TRADEOFFS

In developing and evolving their approach to asset allocation and investment implementation, endowments and foundations should consider more than just target returns. While long-term growth is important, key parameters also should:

- provide a liquid margin of safety to meet near-term distribution and operating needs; and
- be mindful of drawdown exposure and stability of returns to help manage risk and volatility of distributions.

Within these parameters, framed by safety, growth and efficiency, tradeoffs exist that each investor will view differently.

- "Safe" assets – typically have low expected returns and in today's environment may have negative real returns.
- Private assets – offer long-term investors a potential illiquidity premium to help drive "growth" aligning with their perpetual investment horizon. But every endowment or foundation must determine its comfort level with illiquid assets and consider higher private manager costs in the context of the total portfolio.
- Public assets – may have higher expected returns but have their own tradeoffs; use generalist managers versus specialists; employ active management versus passive. The sourcing of manager skill and costs also must be considered.
- "Efficient" assets – may generate strong returns per unit of volatility and typically rely on manager skill (which can be difficult to identify). They also may have higher manager costs and be less liquid than traditional investments.

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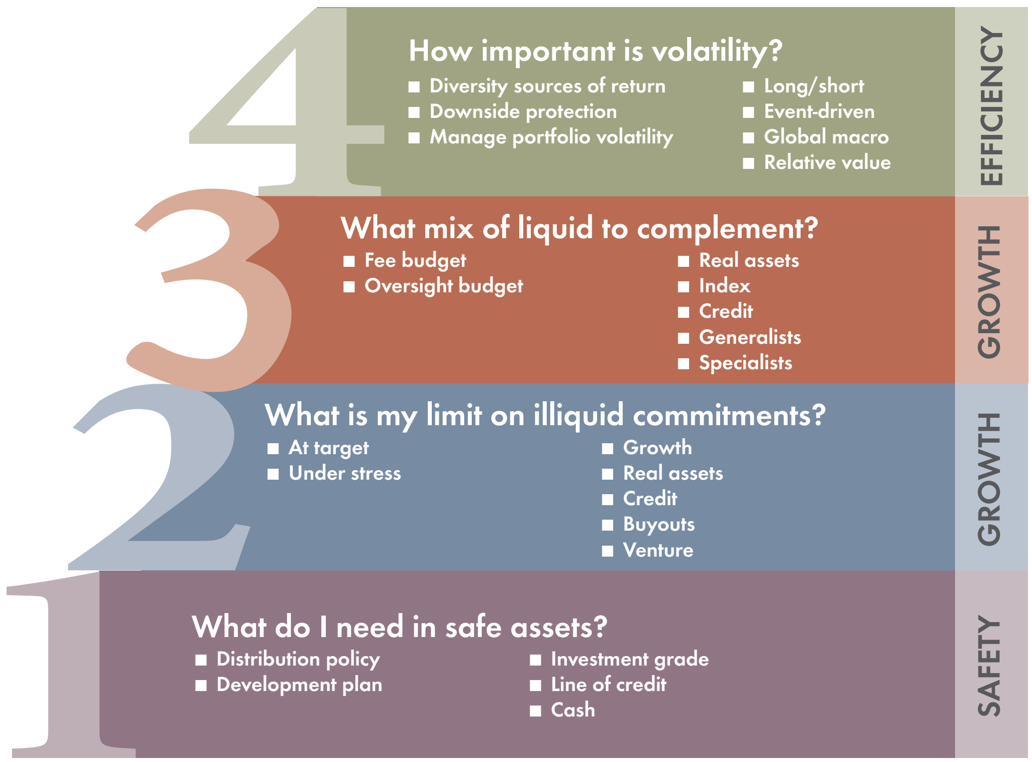
ASSET ALLOCATION – AS MUCH ART AS SCIENCE

Working through these tradeoffs is as much art as science and entails making adjustments along the way. The endowment or foundation investor understands the character of the investment mix it seeks to create, based on the institution's preferences and priorities. But the asset allocator for a large, long-horizon portfolio also needs to be well-versed in the art of implementation, adjusting the investment mix over time to sustain the allocation it seeks.

Each investor will work through these tradeoffs differently to fit their institution's unique objectives, preferences and tastes. Exhibit 1 displays a "build up" to a total allocation with elements of the portfolio aligned with the three focus parameters of safety, growth and efficiency.

EXHIBIT 1: ALLOCATION BUILDING BLOCKS



Source: Northern Trust Multi-Manager Solutions

Investors should work through a four-step process, each step built around a key question, as they construct their allocation build-up across these parameters and then consider themes and develop their manager-level implementation.

1. Safety – What Do I Need?

In today's environment, endowment and foundation investors may hold cash and investment-grade fixed income, trading off low expected returns to receive ready liquidity to meet near-term distribution requirements and operating needs. For many investors, an appropriately sized line of credit can enhance operational liquidity from a total balance-sheet perspective. Each investor's need for a margin of safety will differ, driven by the experience and perspective of the investment decision makers. It also will be influenced by considerations such as:

- distribution requirements and policy;
- institutional reliance on distributions for operations;
- development plans and ongoing inflows; and
- availability and applicability of borrowing.

2. Growth: Private Assets – What Is My Limit?

Sourcing returns in today's environment is challenging, and investors have to press every advantage. In particular, long-horizon investors have the opportunity to invest in illiquid assets, which can generate premium returns. For example, for the 20 years ended December 31, 2014, private equity outperformed U.S. equities by 5% annualized (14.9% for the Global Private Equity & Venture Capital Index and Benchmark Statistics returns versus 9.9% for the S&P 500).

Different investors will have different comfort levels for their target in private, illiquid investments. In "The Five Pillars: Investment Risk Management for Foundations and Endowments," we walked through a simple "stress test" as a way to help an investor define its liquidity comfort level. This takes into account that commitment levels will need to exceed target levels, and the pattern of calls and returns of capital can be uncertain. Similarly, an investor's distribution policy and expectations regarding additional contributions can affect its illiquidity tolerance.

Private investments encompass subcategories such as buyouts, venture capital and growth equity as well as private real assets, including real estate, infrastructure and natural resources. Manager-specific considerations drive realized results in private assets, and there is typically a very wide dispersion of realized results in the category. The investor's ability to access and combine top managers, its ability to manage costs vis-à-vis the total portfolio, and its tolerance for illiquidity also demand attention.

3. Growth: Public Assets – What Is the Right Mix?

Liquidity, cost and other considerations may encourage an investor to invest a significant portion of its return-seeking assets in public assets. These investment options will include active managers and passive vehicles. Within the active manager category, there are:

- generalist managers that may have a style focus (value/growth) but tend to invest across a reasonably broad geographic region and set of industry sectors, and
- specialist managers that may focus on a narrower geographic niche (Asia, India) or sector (listed infrastructure, real estate investment trusts, consumer).

Passive index exposure makes market-driven returns in public assets easily accessible at low cost, representing a readily definable comparison for an active implementation component or approach. Passive and active also can be blended within public assets in a core/satellite construct. As an element of public asset investments, passive exposure can represent a complement to fee- and oversight-intensive active exposure in private assets and absolute return.

4. Efficiency – How Important Is Volatility?

After addressing the priorities of liquidity and return generation, endowment and foundation investors should also consider the importance of managing volatility. The lower the volatility in their portfolio, the better; steadier portfolio growth allows for more consistent distributions supporting their charitable purposes and operating requirements.

The broad area of "hedge funds" encompasses many types of managers drawing on a broader tool set that can include hedging long positions, leverage and derivatives. Many endowments and foundations look to this opportunity set to source managers that can be combined to generate efficient returns – a high ratio of returns to volatility. They may categorize this exposure as absolute return or independent return, reflecting its lower expected correlation to long-only investment markets.

Returns in this category are less driven by broader markets and more by manager skill. How much an investor allocates to the category is driven in part by its perspective on its ability to source, conduct due diligence and thoughtfully combine and oversee the right managers. It also depends on how much importance it places on having a portfolio counterbalance to help reduce exposure to traditional market drivers and lower portfolio volatility. Costs and relative liquidity also are important considerations. A meaningful allocation to a successful absolute return portfolio of managers can help reduce downside risks and manage the efficiency and volatility of the broader portfolio.

Themes – Anticipating Opportunities

Anticipating investment opportunities and positioning to take advantage of them also is important in today's investment environment. One way investors accomplish this is by focusing on themes they want to dynamically incorporate into their portfolios. This helps them get ahead of cyclical or secular waves that may help drive differentiated returns.

Themes can be sector-specific (health care, technology, natural resources), regional (Asia, Latin America) or some combination. Investors can develop these themes and work them back through their four-category build up. For example, if they want to express a view on health care, are the best opportunities in long/short managers, long-only public managers or private managers? Are they in equity, debt or both? If the focus is Asia or natural resources, a similar assessment can apply. For one theme, greater focus on hedged public security exposure may make sense at a given time. For another theme, more focus on private assets may apply. Consideration of themes will then play a key role in framing the set of managers that implement the investment strategy.

Managers – Differentiation

With significant allocations to high-dispersion categories like private assets and absolute return, and based on their unique themes, investors then must source, combine and dynamically implement a group of distinct managers. Key considerations include:

- Quality – managers demonstrating sustainable differentiation
- People – aligned interests with top professionals
- Discipline – no compromises regarding risk management
- Focus – diversification is achieved at the portfolio level; each manager should have a specific area of expertise that contributes to the whole

At Northern Trust, our model portfolio for endowments and foundations is derived from views across the high-level building blocks. It drills down to specific managers to implement the allocation, weaving in several key cyclical and secular themes.

CHALLENGING MARKET ENVIRONMENT

Endowment and foundation investors seeking to maintain purchasing power, net of their support of steady, ongoing distributions, face a challenging capital market environment. Thoughtful, sophisticated implementation may help improve long-term investment results to better align with endowment and foundation investment objectives. Effectively building and monitoring such an implementation is not easy. A thorough set of custom guidelines that balance considerations, including liquidity, cost and accountability for results, should shape it. Large, long-horizon investors have the opportunity to build – or partner to access – the resources to design and implement the approach that best fits their unique circumstances.

TECHNICAL CHECK

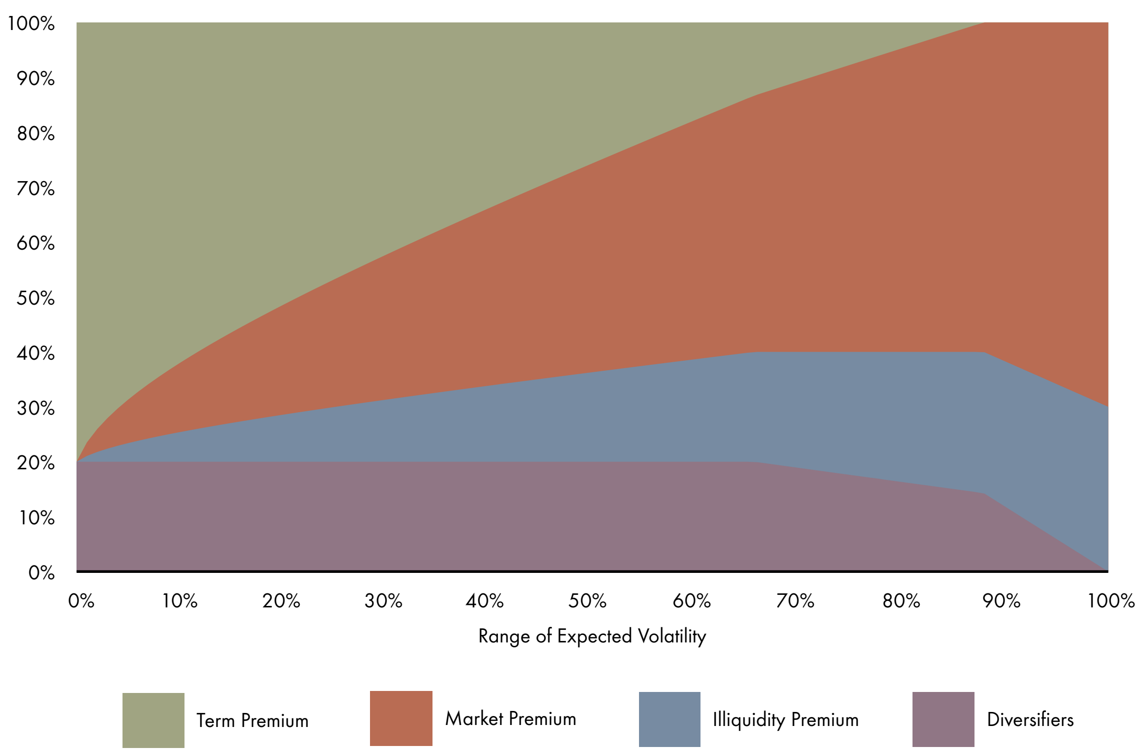
While determining the allocation for long-horizon endowment and foundation investors tends to be more art than science, we always check our thinking through analysis based on our capital market assumptions, as discussed in our Five-Year Outlook: 2015 Edition.

We have evolved a technical framework for large, long-horizon investors optimizing four pools. Three are based on different return premia (term, market and illiquidity). The fourth is based on customized absolute return exposure as a diversifier. We optimize within each of these pools and then across the resulting "four-asset" portfolio.

Exhibit 2 shows the adjustment of allocation across the pools based on a shift in target volatility on the horizontal axis. As target volatility increases, low expected-volatility and low expected-return term premium assets fall away, and market and illiquidity premia assets increase. Exposure to the custom diversifier pool remains steady except for the highest target-return portfolios with a high tolerance to volatility.

This "technical check" is directionally consistent with the qualitatively driven allocation process we typically work through with clients.

EXHIBIT 2: ALLOCATION ADJUSTMENT ACROSS POOLS



Source: Northern Trust Multi-Managers Solutions, Portfolio Construction Desk

TO LEARN MORE

Northern Trust Asset Management's Endowment and Foundation team works with investment staff, committees and boards to enhance investment portfolios through both broad and targeted multi-manager mandates. For more information about this process, please contact your relationship manager or visit northerntrust.com.

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