Challenges of Mid-Size Foundations Series

Part I: Returns — Is 5% Real, Real?

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Turning the page on a decade always provides an opportunity for reflection and planning. It is a chance to reflect on success and disappointments and plan for challenges and opportunities to come. From the perspective of the capital markets, the 2010 – 2019 period will be remembered for extraordinary growth. The S&P 500 Index, a proxy for the U.S. stock market, averaged +13.6% per year—well above historical averages. The sharp downturn in the equity markets at the start of 2020 has certainly dampened overall returns. Yet, the trailing ten-year average through April 2020 remains well into double digits.

This picture of strength painted by equity market returns over the past ten years contrasts sharply with the growing level of societal concerns over that same period. According to NASA, 2019 was the second hottest year on record since recordkeeping began in 1880[1], as climate changes continue to pose a severe threat to communities around the globe. Income inequality in the United States closed the decade at the highest level since the statistic was first tracked more than five decades ago.[2] The past decade also saw the rise of movements like the #MeToo and #BlackLivesMatter movements, which brought gender and racial issues to the forefront of our national discussion.

Coincidentally (or perhaps not), there has also been a significant increase recently in the number of foundations in the United States. According to the most recent numbers from the National Center for Charitable Statistics (2015), there are now over 1.5 million IRS-registered non-profits in the U.S, which contributed an estimated $985.4 billion to the U.S. economy in 2015 alone.[3] As we think about the dichotomy of the above reflections, the importance of our country's non-profit organizations has never been greater. Investment returns over the decade likely bolstered non-profits' endowments across the country, leaving them in a unique position to help address some of the world's most severe and growing issues.

Unfortunately, those issues have grown exponentially in just a few months, as the new decade has brought with it a global pandemic that will change the world as we knew it. The lasting impact of the COVID-19 virus will only further test the strength of our global community, as we come together to face a common enemy and the countless challenges that it will leave in its wake.

At Pathstone, our institutional practice has roots tracing back over more than two decades as a way to support clients in their philanthropic efforts. Today, that practice includes 54 non-profit organizations, mainly private foundations and public charities, which total close to $1 billion in assets.[4] As we embark on a new year and critical decade, we thought it appropriate to reflect on what we have learned in working with non-profit institutions and outline what we believe will be some of the challenges that these organizations may face in the coming years. The first installment titled "Is 5% Real, Real?" will discuss future market return expectations and how foundation and charities can improve their chances of meeting their spending requirements, even in a low return environment.

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[1] "NOAA Analyses Reveal 2019 Second Warmest Year on Record." NASA. January 15, 2020. https://www.nasa.gov/press-release/nasa-noaa-analyses-reveal-2019-second-warmest-year-on-record

[2] Taylor Telford. "Income inequality in America is the highest it's been since Census Bureau started tracking it, data shows." Washington Post. September 26, 2019. https://www.washingtonpost.com/business/2019/09/26/income-inequality-america-highest-its-been-since-census-started-tracking-it-data-show/

[3] "Charitable Giving Statistics." National Philanthropic Trust. https://www.nptrust.org/philanthropic-resources/charitable-giving-statistics/

[4] This information is as of December 31, 2019.

In future papers within this series, we will discuss:

- Spend Down vs. Perpetuity – What is the best path for a private foundation?
- Ensuring Sound Leadership and Governance as your Organization Grows
- Tips to Help your Organization Spend More Time on What Really Matters

Enjoy and stay tuned for more!

Finding Growth in a Low Growth Environment – Is 5% Real, Real?

It is hard to believe that it has been well over a decade since the 2007-2008 financial crisis. Even with the onset of the coronavirus and resultant sharp market decline in the February-March period, U.S. equities have returned some 300%[5] since bottoming in early 2009. Since that time, bonds of many types have profited from an environment of declining interest rates and strong global demand.

This favorable investment environment of the past decade has supported the need of charitable organizations to replenish and grow their assets to achieve any long-term mission. The Internal Revenue Code regulation mandates that private non-operating foundations distribute essentially 5% of the fair market value of non-charitable use assets per year. Private operating foundations and public charities often require a similar spending level to maintain their programmatic activities. In addition to replenishing distributions, growth is required to preserve the real value or purchasing power of resources in the face of inflation. The industry shorthand for meeting these dual objectives is achieving a "5% Real Return," or simply "5% Real."

With the post-2009 recovery long in the tooth, along with the near-term economic challenges and uncertainty presented by the coronavirus, institutions could face a lower-return environment in the immediate years ahead. In fact, Pathstone's investment strategy group forecasts below-average market returns in many areas over the next three-five year period. A likely slowing of global economic activity will impair corporate earnings growth and, thus, equity values. Today's historically low interest rates across the maturity and quality spectrums limit the investment return of fixed income securities.

It is easy to counsel what not to do when facing such a challenge. Much harder is rendering advice on how to achieve "5% Real" in a low-return environment. Even though there is no simple, ironclad solution to this problem, there remains hope. Organizations can take certain measures to get the most out of an investment portfolio:

- **Maintain strategic diversity**. The equity market tide has not lifted stocks in equal measure. The current bull market has been propelled disproportionately by a select group of technology and other growth stocks while other areas have produced only modest, and in some cases, negative results. Going back ten years (2010 – 2019), the S&P 500 Index averaged 13.6% per year. Yet, eight of its ten underlying industry sectors have returned less than that average. Moreover, international equity markets, even with higher dividend yields, have averaged less than a 4% annualized total return over the same period. There remain plenty of attractive investment

[5] As measured by the S&P 500 Index.

opportunities, but capturing them requires an unwavering commitment to portfolio diversification and a willingness to invest in what is currently out of favor.

- **Be opportunistic (prudently).** Market prices are typically more volatile than the true underlying value of securities. Markets can overreact due to investor fear or extrapolation of recent trends too far into the future. Patient investors can take advantage of these temporary market dislocations to buy assets at good values. An example of this can be found in the closed-end funds market, where portfolios of equities and bonds can trade at significant discounts to net asset value, as we saw in early 2019.

- **Focus on net returns**. Manager fees and other expenses pose a greater relative drag on performance in an environment of lower capital market returns. It is important that Investment Committees monitor investment costs closely and track manager performance net of their fees. It is also critical that those investment-related expenses are transparent and structured to align the interests of manager and client.

- **There are ways to reduce fees without reducing investment opportunities**. Often, the same investment strategy can be accessed under different pricing structures. For example, fees under an approach called "model delivery" are often materially lower than fees associated with traditional managed accounts and mutual funds. Institutions should understand the array of investment options available to them, and the associated pricing and liquidity terms of each.

Click to learn more about Pathstone's proprietary model delivery strategy: Pathstone Portfolio Platform (P-Cubed).

- **Fight the potential fixed income drag.** Despite strong government bond returns so far in 2020, the low level of interest rates combined with a flat yield curve has significantly reduced return expectations. A focus on short-term fixed income can help reduce risk while providing comparable yields to longer-term fixed-income investments. Investing in liquid shorter-maturity fixed income also positions your organization to take advantage of higher yield in the future.

So, is 5% real, real? The markets will certainly have a say in the answer to that question. We believe that the adjustments outlined above, combined with a prudently opportunistic approach, can better position your endowment to make it a reality.

Join us next month when we take a slightly different look at this question and discuss how to approach the decision of whether to "spend down" assets.

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