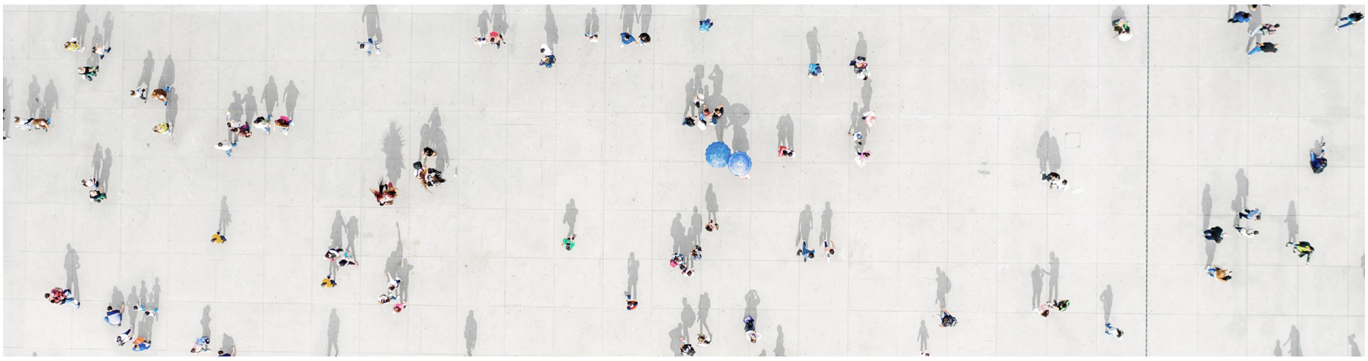
THE ENDURING RELEVANCE OF ENDOWMENT-STYLE INVESTING



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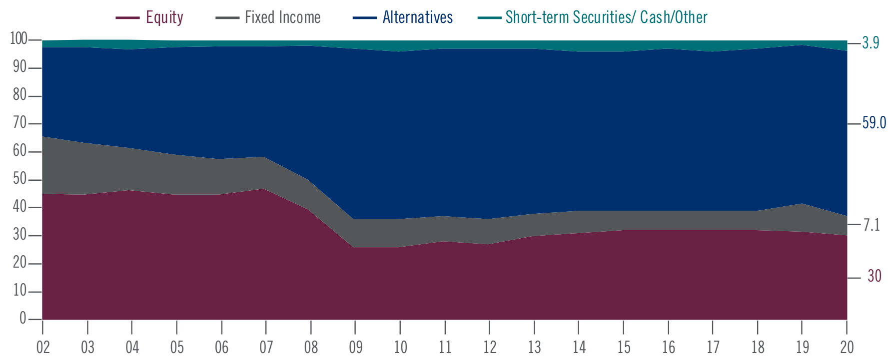
Endowment funds are investment funds set up for the benefit of educational and other institutions and funded by gifts and donations. Particularly in the US, universities, museums and hospitals all have endowment funds. The largest belong to American universities, led by Harvard University (USD41.9 bn in assets under management (AUM) at end-June 2020), followed by the University of Texas and Yale University (with USD32 bn and USD31.2bn, respectively).

The primary investment objective of university endowment funds is to generate sufficient returns to maintain the purchasing power of their assets in perpetuity and sustain the university's operating budget. In general, endowments target a real average annual return of 5% (adjusted for inflation) over the long term (five to 10 years).

Over time, the larger endowment funds have significantly reduced their exposure to traditional asset classes such as public equities and bonds (*see chart 1*) and moved increasingly into alternative assets such as private equity, real assets and absolute-return strategies, which provide the benefits of diversification and higher returns. By nature, alternative assets offer opportunities to exploit inefficient market pricing through active management. Large endowment portfolios have a far greater weighting of alternative assets than smaller ones, whose investments remain heavily focused on domestic equities and investment-grade bonds. This is because the substantial research and other resources needed to invest in alternatives is more accessible to large players.

Large US endowment funds' allocation to public equities declined from 45% of total assets in 2002 to 30% in 2020 (having fallen to as low as 26% in 2009), while their allocation to alternative assets increased from 32% to 59% over the same period. In 2020, the Yale endowment fund, the third largest in the US, said it aimed to have around three quarters of its assets allocated to alternative assets.

CHART 1: LARGER US ENDOWMENTS' ASSET ALLOCATION, 2002-2020[1]



Source: Pictet WM-AA&MR, 2019 NACUBO-TIAA Study of Endowments, January 2021

1 Data for endowments come from the NACUBO Endowment Study, 2002 -2008. NACUBO-Commonfund Study of Endowments for 2009 through 2017. Data for fiscal year 2018 and 2020 are from the NACUBO-TIAA Study of Endowments (NTSE).

Endowments' performance in fiscal year 2020 (1 July 2019 – 30 June 2020) was disappointing due to the impact of the coronavirus pandemic across the economy. According to NACUBO, endowments delivered an average one-year return of 1.8% in fiscal year (FY) 2020. The average return for the largest (AUM of greater than USD1 bn) and smallest endowment funds (less than USD25 mn) was 2.5% alike. By way of comparison, global 60/40 funds (60% MSCI AC World + 40% Bloomberg Barclays Global Aggregate Bonds) provided a return of 3.3% over the same period, while US 60/40 funds (60% S&P 500 + 40% US Treasuries) returned 10.2%. This was because of the strong recovery of the S&P 500 starting in late March (driven by tech stocks) and the good performance of US Treasuries due to decreasing in interest rates (the US 10-year yield fell from 2% to 0.6% in the 12 months to 30 June 2020).

"Historically, US endowment funds have delivered an average annual return of 7.5% before inflation"

However, some individual endowments performed very well. Harvard University's endowment fund delivered a return of 7.3%, Yale's 6.8% and Brown University's (which has a market value of USD4.7 bn) produced a return of 12.1%, thereby beating the US 60/40 portfolio's 10.2% total return. According to Markov Processes analysis[2], which uses return-based techniques, Brown University's exceptional performance was most likely due to its heavy exposure to high-growth technology assets across public and private markets.

As mentioned, university endowment funds tend to aim for a long-term return of 5% per annum (after inflation). Using the Higher Educational Price Index (HEPI) to adjust for inflation, we found that only 5% of US university endowment funds, including only 10% of large funds (assets of over USD1 bn) reached this objective in FY 2020. However, approximately 50% of endowment funds recorded an average annual return of at least 5% if one extends the performance analysis to 10 years. Chart 2 shows sharp differences in 10-year rolling returns in excess of HCPI from 1998 to 2021. While the Yale endowment fund has consistently produced a real return above 5%, 50% of endowments fell below the 5% target in the period 2007-2018. US endowment funds have historically had an average annual nominal return target of 7.5%. Taking inflation into account, this suggests they continue to aim for a real return of 5% per annum. But if returns continue to diminish below this level, endowments will need to consider either their strategic asset allocation or their spending policies, or even both.

A NACUBO-TIAA survey published in April 2020 showed that the 333 institutions that responded (representing a 43% response rate) experienced losses due to the covid-19 crisis in the first quarter of 2020, with an average return of -13.4%. Over the same period, the S&P 500 index declined by 20%, while global 60/40 and US 60/40 funds fell by 18% and 7%, respectively. Small endowment funds suffered more than larger ones, although the former's larger exposure to US equities meant they subsequently recovered faster.

Endowment spending

The survey indicated that 70% of university endowment funds increased spending to provide financial support to institutions and students during the pandemic. The spending rate in FY2020 was 4.59%, up from 4.36% in FY2019. Furthermore, more than 40% of survey respondents reported a decline in cash flow, while new gifting fell by 16%. The increase in spending and the reduction in gifting could continue to have negative repercussions on endowments' financial positions in the future. However, NACUBO reports that virtually all endowment funds expect to maintain their current policy spending rate in FY2021.

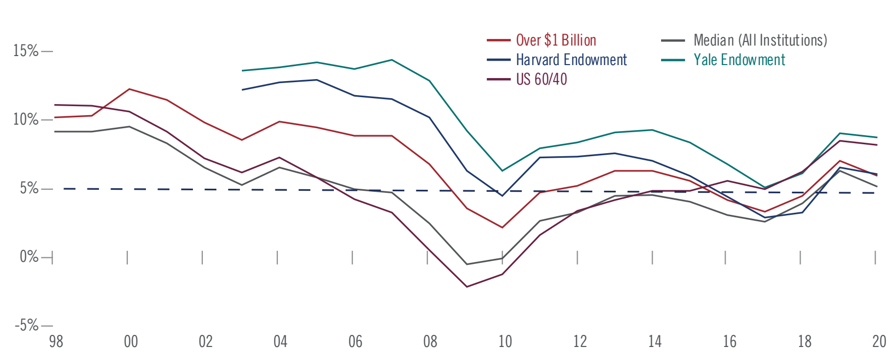
Asset class performance

Endowment funds' weak returns in fiscal year 2020 can be primarily explained by their allocation to poorly performing asset classes. The average US endowment fund had over half of its assets in asset classes that delivered less than 1% in FY20 (with real assets returning -15% on average, non-US equities -4% and hedge funds +0.8%). In addition, half of their fixed-income exposure was in high yield, private debt or cash, which all produced very low returns. Charts 3 and 4 show average asset-class allocations for all endowment funds and asset-class returns for FY2020.

Expected returns for FY2021

Given that equity markets, commodities and hedge funds have all rebounded strongly since the low points reached in March-April 2020, it is reasonable to expect endowment funds to deliver higher returns in FY2021.

CHART 2: 10-YEAR ROLLING ANNUALISED RETURNS, 1998-2020



Source: Pictet WM-AA&MR, NACUBO-TIAA Study of Endowments, FactSet, Harvard and Yale reports, March 2021

2 https://www.markovprocesses.com/blog/how-brown-outperformed-for-the-second-year-in-a-row/

Based on the assumption that markets remain flat from the time of writing (mid-March 2021) to end-June 2021, different forecasting methods show US endowments producing an average nominal return of 15-21% in the fiscal year ending 30 June 2021.

The first method, based on FY2020 asset allocations and assuming that the performance of illiquid assets' remains flat since the last data available at 30 September 2020, suggests an annual return of 15%. Using proxies for illiquid assets (private equity, private debt and real assets) our estimated return would be a much higher 19%.

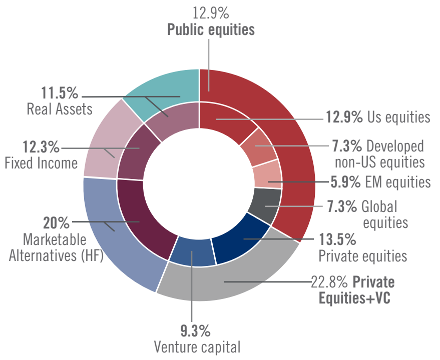
> "It is reasonable to expect endowment funds to deliver improved returns in fiscal year 2021"

The second method aims to calculate returns for the endowment investment strategy by referencing the Endow index. This index's target asset allocation for 2020—35% equity, 11% fixed income and liquidity and 54% alternatives—is close to the average endowment allocation. Chart 5 shows the average annual returns for US endowment funds versus the Endow index since 2001. The two show similar patterns, although the Endow index demonstrates higher volatility. The Endow index provided a return of 25% from 30 June 2020 to 18 March 2021. A simple regression model with a significance level of 5% results in a confidence interval of 15-21%, indicating that US endowment funds would return 18% in the same period.

In the third method, a linear regression model is employed, using value and growth as predictor variables. These two factors typically explain 93% of average endowment returns. This model suggests a return of 17.5% for average endowments in FY2021 with a confidence interval of 15-20% and a significance level of 5%.

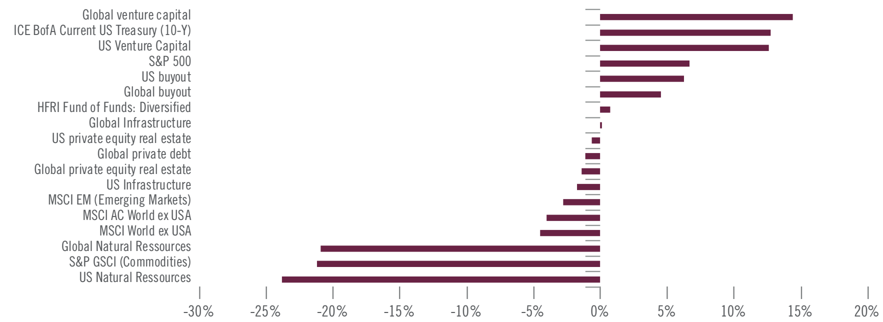
Last but not least, the Texas University endowment fund, the second largest in the US by market value, reported a return of 14.42% in the six months to 28 February 2021, supporting our expectation that most endowments will perform strongly in the fiscal year ending 30 June 2021.

CHART 3: AVERAGE ASSET ALLOCATION FOR ALL ENDOWMENT FUNDS, FY2020



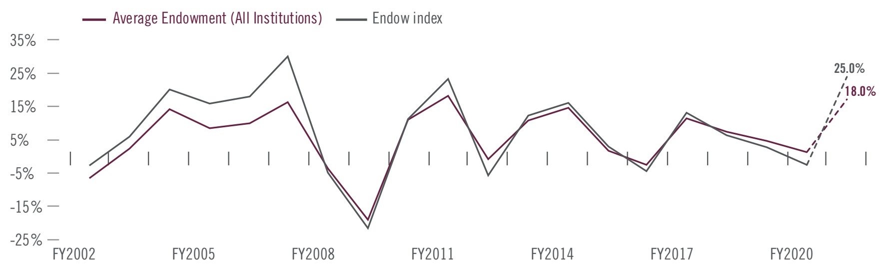
Source: Pictet WM-AA&MR, NACUBO-TIAA, March 2021

CHART 4: FY2020 PERFORMANCE BY ASSET CLASSES



Source: Pictet WM-AA&MR, NACUBO-TIAA Study of Endowments, FactSet, Burgiss, March 2021

CHART 5: AVERAGE ENDOWMENT RETURNS VERSUS ENDOW INDEX RETURNS, 2001-2020



Source: Pictet WM-AA&MR, NACUBO-TIAA Study of Endowments, Bloomberg, March 2021

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