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prioritising action in a market crisis:

a framework for endowments & foundations

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Every market crisis is unique, and fiduciaries overseeing endowment and foundation portfolios should always question the appropriate response. Particular circumstances of each organisation and the way capital markets decline differ from crisis to crisis. The specific tools available to address those stresses also vary as markets evolve.

This paper describes a general framework for addressing the priorities for action in any market crisis, with a particular focus on the circumstances around the current COVID-19 calamity.

The framework

1. Assess the organisation's liquidity needs

Define "liquidity"

- Operational needs
- Heightened capital call needs
- Dry powder desired

Determine amount

What amount of "liquidity" is needed?

2. Establish or raise liquidity reserves

Reduce invested assets, depending on the amount needed

Incremental increase: Take gains from defensive fixed income, and move to cash

Large increase: Rebalancing/*pro rata* reduction across all asset classes

Assure money market fund used is government, not prime

3. Understand the portfolio

Prioritise understanding the major risk factors in the portfolio to help estimate performance – for example:

- **Equity** beta
- **Interest rate** exposure
- **Credit spread** exposure
- **Illiquidity** allocation

4. Consider opportunities

In order of rising difficulty

Rebalance regularly

Tilt toward "value" within and across asset classes

Tilt toward opportunistic styles and managers:

- Flexible mandates
- Distressed
- Private equity

1. Assess the organisation's liquidity needs

Assessing liquidity needs requires first **defining liquidity that is critical to the organisation** at that particular time. Every endowment or foundation portfolio supports a nonprofit institution and its mission, but those organizations face different operational stresses.

In the current crisis, higher education institutions may need ready cash to refund room and board fees; arts organizations may face a cash crunch as the lack of performances results in revenues falling to zero; fundraising institutions face dramatically falling contributions, which may affect their ability to operate even as mission-driven needs may be increasing.

The investment portfolio's liquidity needs include both meeting capital calls for commitments to private capital funds, and some degree of dry powder to reinvest at some point either in the broad strategic line-up of investments, or in specific opportunities that may arise from the crisis.

Defining liquidity should naturally lead to **assessing the amount of liquidity that the organisation needs.** This is often expressed as a range instead of a specific amount, although a target amount with ranges can be helpful in providing flexibility to respond to changing operating and market conditions.

2. Establish or raise liquidity reserves

If the institution's liquidity reserves, inclusive of short-term savings, lines of credit, and/or the investment portfolio, are not in the target range for liquidity reserves in this crisis, then (to risk stating the obvious) it is necessary to **reduce invested assets to raise cash**. Prioritizing where to take that cash from depends on the amount of cash that is needed.

In a market crisis led downward by equities, defensive high-quality fixed income typically has gained in value, or at least has not declined by nearly as much as equities. Selling fixed income to raise cash, especially if there are gains in that part of the portfolio, not only has the least impact on long-term projected portfolio returns, but also serves as an incremental portfolio-level rebalancing "into" equities, without actually investing additional cash in equities. **Incremental increases in needed cash should first come from reducing defensive fixed income.**

If larger cash levels are necessary, some combination of rebalancing the portfolio and reducing invested amounts across all asset classes, where available, is appropriate even if that means crystalizing substantial losses in equities. Presumably, if significant reductions in the investment portfolio to raise cash are necessary, the organization's existence may be in jeopardy, and without the organisation itself, the portfolio would be irrelevant. This is not a step to take lightly, and we advise endowments and foundations to consider substantial reductions in equities as a last resort.

Finally, once the institution has raised sufficient cash, trustees should **resist the urge to maximize invested yield on that cash and remain highly conservative with the money market fund** or other cash-equivalent instruments for that cash. In the U.S., this means avoiding "prime" money market funds, which have the ability to reduce price per share ("break the buck") and to restrict redemptions, both of which fly in the face of the definition of a liquidity reserve in the first place.

3. Understand the portfolio

During times of crisis with highly volatile markets, there is often a desire for fiduciaries to more frequently monitor the portfolio's performance. Most endowment and foundation portfolios have one or two risk factor exposures that really drive portfolio performance. Knowing those major risk factors helps estimate the degree of portfolio change in a crisis. This streamlines the focus of the day-to-day monitoring activity on the critical assessments of investment managers' operational continuity, and prioritizes monitoring managers who typically exhibit a high level of tracking error.

The long-term time horizon of most endowments and foundations means that their major risk factor is typically to equity markets. For these institutions, a historical analysis of equity market beta, which is investment-speak for sensitivity, becomes the critical issue. Other types of organizations may have significant exposure to credit spreads or interest rates.

Trustees typically use beta exposure analysis to stress-test portfolios in a hypothetical crisis. When there is an actual crisis, **knowing those risk factor betas can provide a useful back-of-the-envelope estimate of short-term performance**. For example, a portfolio with a historical beta of 0.63 to global equities means that those portfolios will suffer 63% of the downside in equities, of course on average and without considering short-term active manager outperformance or underperformance.

It may also be helpful to go back to a somewhat recent down market to test the risk factor beta sensitivity on the portfolio. The most recent significant drawdown prior to this current crisis was the fourth calendar quarter of 2018 when equity markets were down double digits. Comparing that market drawdown with the portfolio's actual return that quarter could provide a real-life example of the helpfulness of estimating short-term performance using risk factor betas.

4. Consider opportunities

Crises sometimes lead to paralysis. It is never easy to think about investing as markets fall, but if we maintain faith in capital markets over generations, then remaining disciplined and thinking opportunistically is the right way to overcome paralysis. Considering opportunities is also a lot easier once the first three steps of this process are completed – liquidity has been secured and the portfolio risks are understood and communicated.

The low hanging fruit for being opportunistic is simply to rebalance the portfolio, selling out of asset classes that have outperformed others, and buying the underperforming, under-allocated asset classes. Rebalancing itself can be done opportunistically; for instance, trustees may opt to reduce underweights and overweights by only half instead of moving fully back to targets. For institutions that typically rebalance regularly but infrequently, stepping up the frequency of rebalancing could help in maintaining the portfolio's overall risk posture.

Tilting toward absolute or relative value is the next possible way to be opportunistic. This can mean tilting across asset classes, as well as tilting within asset classes. Assessing value always involves risk, and as with liquidity, the word "value" itself can mean different things. But value, however defined for each institution, can help with the discipline of incrementally buying cheaper investments for the long term.

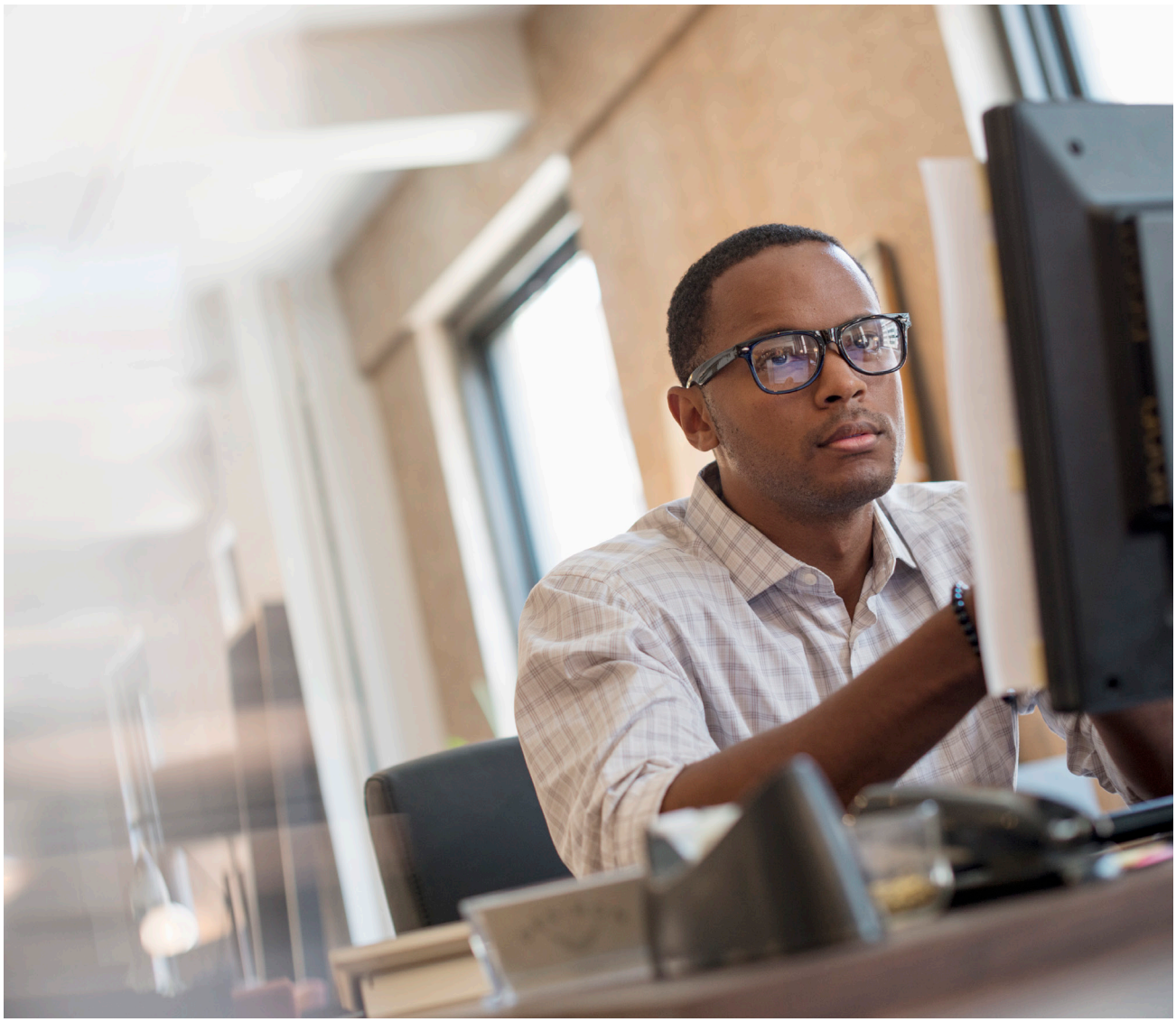
Finally, **there are opportunistic or other specific investments to consider** through the crisis. These vary from crisis to crisis. In the Global Financial Crisis of 2007-2009, at different points there were buying opportunities in investment grade bonds, asset-backed securities, and agency-backed securities, as well as distressed companies both in restructuring and in liquidation.

Assessing the "right" opportunistic investments is always easy in hindsight, but difficult in the moment. To help with calibrating risk tolerance, these opportunistic investments need to conform with an institution's overall investment policy asset class guidelines, as well as with diversification guidelines that can point to the right allocation sizing of these types of opportunities. Additionally, the institution should ensure that they have a flexible governance model to move quickly should windows of opportunity arise.

The importance of documenting this process

Endowments and foundations are typically governed by a devoted group of volunteers, and those volunteers have both limited time and possibly limited terms. This sometimes means that trustees "forget" decisions or analyses performed a few quarters ago, a few years ago, or even during the last crisis.

Documenting the decisions, actions and rationale through the preceding four steps can help an institution remain resilient through multiple crises, and even prepare for the inevitable next one in advance. This can be done succinctly through a short summary or establishment of investment beliefs that are reviewed periodically or even integrated into regular portfolio stress tests that are performed in calmer times.



Other resources

Much of the process described in this brief paper echoes a piece Pavilion produced earlier this year, **"2020 Vision – Endowments & Foundations: Top 10 Investment Priorities."** In that paper, we reviewed four broad themes to help bolster portfolio and organisational resiliency in times of crisis:

Protect

Bolster portfolio resiliency

Diversify defense

Lock down liquidity

Reflect

Examine the portfolio's holistic context

Explore all facets of the spending policy

Capitalise

Consider converging markets

Revisit the illiquidity premium

Reassess real assets

Organise

Build governance resiliency

Engage in the diversity and inclusion conversation

Last year, Mercer undertook a comprehensive study of the not-for-profit sector, gathering and analysing insights on important issues impacting investment portfolios. Click here to read the key findings of the report 'Change Brings Opportunity'.

About us

Mercer's dedicated team of endowment and foundation specialists are focused on research, advice and investment portfolio solutions addressing the specific needs of our not-for-profit clients.

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