Fiducient Advisors, Nonprofit Investment Stewards Podcast
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The Current Investment Environment: Where Do We Stand? Where Are We Headed? with Matt Rice

[00:00:00] Welcome to Non-profit Investment Stewards with Bob DiMeo and Devon Francis from Fiducient Advisors. Bob and Devon are passionate about helping nonprofit organizations prosper. Whether you oversee endowment, foundation or retirement plan investments, this podcast exists to help stewards improve performance, reduce costs and discover strategies that enable your charitable organization to prosper and advance its mission.

[00:00:26] Now onto the show. Hello, welcome to 2022. And welcome back to the Nonprofit Investment Stewards podcast. I'm Bob DiMeo, always good to be joined by co-host Devon Francis. Today, we have what I'll call kind of a quick-take episode that should bring all of you who oversee endowments, foundations, any sort of investment for a nonprofit or anywhere, up to speed.

[00:00:52] Like last year, we're joined by our partner and Fiducient Advisors' CIO, Matt Rice. Matt's about to provide all of us [00:01:00] a recap of 2021, but more important, he's about to share our outlook for what investors might expect from stocks, bonds, and alternatives this year and beyond. Are stocks overpriced and about to tank?

[00:01:14] How will rising inflation and rate hikes impact your portfolio? We'll tackle those and other pressing questions in a moment, but first, Devon, how are you today? And what are your thoughts on today's episode? I'm great, Bob. Happy to, uh, be joining you in this new year. And this is one of my favorite types of episodes, talking about the investment world.

[00:01:34] And it's always great to hear from Matt. By now, most of our listeners might be familiar with Matt, so I'll keep the introduction short, but as you mentioned, he's our chief investment officer. And among other things, he directs the firm's capital markets, investment strategy, and asset allocation modelling work.

[00:01:52] Matt has a bevy of credentials including being a CFA and a graduate of Northwestern University. So Matt, great to [00:02:00] have you on the show again, and thanks for joining us. Thanks, Devon. It's great to be here. Happy New Year. Matt, so good to have you here. And it's probably as good a time as any to share that none of what we're about to discuss today represents a specific recommendation.

[00:02:11] And one thing we know for sure is that forecasts are really just that. Actual performance will differ. But let's get right into it, Matt. 2021 was a very strong year for stocks, and that followed a surprisingly strong 2022, or 2020 rather.

[00:02:30] Can you provide listeners with a recap of what we saw from stocks last year? Absolutely, Bob. 2021 was a strong year for stocks, driven by robust earnings growth and profit margin expansion. And that's all despite mounting wage pressures, labor shortages, and supply chain disruption. So, we saw in the U.S., as measured by the S and P 500, stocks were up about 29%.

[00:02:56] Within large caps, uh, we saw large cap [00:03:00] stocks nearly doubling the return relative to small caps. So, about 28.7% versus 14.8. And then within, uh, on the large cap side, particularly growth modestly beat value by about two and a half percent for the year. On the other hand, within small cap stocks, small cap value stocks dominated growth by over 25%.

[00:03:22] Overseas, you know, foreign stocks were up about 11% for the year. So, solid, not up as much as in the U.S., but up solid. On the other hand, emerging markets were down about two and a half percent, driven by China, which fell about 25% for the year. China's technology and internet stocks were hit particularly hard due to government crackdowns.

[00:03:44] And then also fallouts surrounding a faltering Chinese real estate developer also weighed heavily on Chinese stock market sentiment.

[00:03:54] Thanks, Matt. So just to recap, strong performance from stocks pretty much across the board. Large [00:04:00] outperformed small cap. Domestic markets outperformed international markets. How would you summarize last year's returns for bonds and alternative investments? Investment grade bonds had a poor year with Bloomberg U.S. aggregate index down one and a half percent for the year.

[00:04:16] Although high yield bonds were up 7.8%, as credit spreads continued to tighten. Foreign bonds were generally negative on a strong dollar as the U.S. dollar index rose over 6%. The hedge funds had a solid year and private equity had strong performance and commitment levels. Real estate and broad real assets put up strong returns as inflation returned in a meaningful way.

[00:04:38] For the first time in decades, running over 6% in the most recent 12 month period.

[00:04:45] So, Matt, let's jump to I think what listeners and investors in general are really interested in. That is a look at performance expectations. What would you say your bumper sticker is in terms of where stocks and bonds are headed over the [00:05:00] coming years? Yeah, Bob. In our view, stocks have a modest return outlook over the next decade, compared to the recent past valuations are elevated. Based on Ford, price-earnings ratios, and Shiller Cape metrics.

[00:05:14] The S and P 500 valuation is the highest on record, excluding a brief period in 1999 and 2000 during the dot-com technology stock bubble period. While history is not destiny, the S and P 500 index had a negative return in the 10 years after 1999. So, we don't think we're kind of in the 1999 category yet.

[00:05:38] We are getting close. On the other hand, bond return forecasts are downright awful. We expect most bond categories to underperform inflation. We expect investment grade U.S. fixed income to return about 1.7 over the next decade. While we expect inflation run at two and a half percent. So in other words, we expect bonds to generate about a negative 1% [00:06:00] real return over the next decade.

[00:06:03] Okay, so you gave us your broad takeaways. Stock expectations are modest, bond expectations are awful, as you say. Let's dive into some specifics. So what is the outlook for U.S. stocks going forward and how does that outlook compare to not only the past, but also compared to expectations for foreign stocks?

[00:06:24] That's a good question, Devon. Our U.S. stock forecast is 5.9% on the total U.S. stock market. 5.7% for the S and P 500 over the next decade. It's our second lowest nominal return forecast on record. As last year was actually lower, but it's our lowest real return forecast given that our inflation expectations rose last year. When it comes to small cap versus large, we do expect small cap outperformed modestly over the next decade, 5.8 versus a 5.4. [00:07:00] Large caps have dominated in recent years.

[00:07:02] But we expect that trend to reverse over the next decade. When it comes to value versus growth, you know, no style grows to heaven. And growth looks rich compared to value on pretty much every historical metric you look at. However, don't be surprised that growth continues to dominate in 2022.

[00:07:21] However, we do think over time we expect value to normalize and catch up with growth. Great. And can you share some specifics with regard to our expectations for bonds and alternative asset classes? Yeah. When it comes to bonds, very modest returns under 2%, generally with U.S. investment grade in the 1.7% range.

[00:07:44] When you look at global fixed income, even a little bit less than that. And as I mentioned, two and a half percent break even inflation over the next 10 years. Kind of a difficult road to hoe. On the other hand, while credit spreads are tight, we are seeing high yield bond forecasts [00:08:00] in the mid threes.

[00:08:01] So, that's not necessarily something that excites us. But on the other hand, at least it's positive, uh, relative to the level of inflation over the next 10 years. When it comes to alternatives, we expect skillful, marketable, alternative strategies to generate meaningful alpha, which is a risk-adjusted return. When it comes to hedge funds and marketable alternatives, it really depends on strategy.

[00:08:23] When it comes to risk and return, we do expect a meaningful out-performance on a risk-adjusted basis, if you hire the right managers. Within the private equity space, private equity valuations are elevated as are really valuations everywhere, but we do expect meaningful outperformance over public equities over the next 10 years.

[00:08:44] Thanks, Matt. So we've talked to this point a lot about return, and let's think about this from the investment committee members' perspective, someone overseeing an endowment, foundation, that sort of thing. And we know that oftentimes spending policies might [00:09:00] be four to 5%. And when we think about risk and your expectations with respect to return, any shift in how we're viewing risks this year? We're expecting more volatility or not?

[00:09:11] And how can a committee member think about allocating a portfolio? Yeah, Bob, that's a great question. I mean, given the uncertainty of the pandemic, inflation pressures, and the 2022 actions that fed has forecasted about reigning in quantitative easing, I'd say, buckle your seat belts for 2022, as good shape up to be followed a year.

[00:09:36] The market hates uncertainty more than it hates bad news. And there's plenty of uncertainty over the next year. Will inflation moderate? We hope so. It's currently running over 6%. Market expectations are it'll come back into the mid twos over the next decade. So that's kind of baked into what the market's expecting now.

[00:09:54] How quickly will the fed taper its asset purchases? The fed is purchasing about 120 [00:10:00] billion a month in fixed income purchases that is going to begin to unwind over the next six months or so. How much will the fed raise rates kind of baked in as now three rate hikes? And then of course, oh, by the way, we have a pandemic that continues to affect, uh, the economy and labor markets.

[00:10:17] And then, we do expect economic growth also to normalize. It's been running at a rampant clip the last year, with really recovering from the recession. But economic growth will continue to slow we think, but we don't think it'll slow into anywhere close to recession territory.

[00:10:35] However, there's really no shortage of questions for 2022. So I would say buckle your seat belts. It could be a bumpy ride. Hmm. So Matt let's conclude with asset allocation. And if you can provide listeners with some practical insights on how they might view their portfolios. So if there's an investment committee member or an executive director listening to this, how might they go about thinking about asset [00:11:00] allocation in the current environment?

[00:11:03] Yeah. As always, we would suggest, stay diversified. The future's uncertain, and it's always more uncertain than you think it is. However, if you have the wherewithal from a liquidity perspective, we would suggest perhaps, uh, expanding the alternative investment allocations within portfolios. So specifically looking for alpha strategies in the lower volatility segments, we think that can, you know, hedge fund and alternatives, they can add risk adjusted performance, and also, uh, on the private equity side, where we think that there can be a meaningful outperformance, uh, there. And given the fact that your outlook for fixed income markets is so poor.

[00:11:41] What do you think about fixed income from an asset allocation perspective? Does it still play a role in a portfolio? Yeah, unfortunately, when it comes to diversifying a portfolio, especially when you have a meaningful, uh, call it a tight constraints on volatility, you need to invest in fixed income [00:12:00] just to buffer your volatility.

[00:12:01] However, if you're investing in longer term portfolios, where you can take additional risk or you have basically the ability to take on a little bit more illiquidity, we'd suggest finding other ways to diversify a portfolio, whether through marketable alternatives, hedge funds, things of that nature.

[00:12:20] Thanks, Matt. I think that's really helpful. And your prompting thoughts are often used three levers exercise and working with clients, right? And it's probably as good a time as any to remember that when you think of the three levers, just to repeat, inflows, outflows, and then required return for any sort of non-profit or investor in general for that matter.

[00:12:42] The investment component is just one part, right? And you have me thinking that if we're expecting muted returns on an ongoing basis, or at least, uh, at this point for a period of time, it's important for stewards to think about, if you can't get there with returns [00:13:00] to whatever there is for your mission.

[00:13:03] Perhaps they need to increase inflows, whether that's fundraising development, what have you, or decrease outflows. So, probably just important to keep that in mind and kind of along those lines, you've shared a good amount here. Any other thoughts or considerations that you'd share with someone who oversees an endowment or a foundation portfolio in this environment?

[00:13:25] Well, I think, I think it's important to continue to focus on the long-term. I mean, we're going to go through, over the next decade or two, we're going to go through a lot of a lot of periods where things look overpriced and overvalued. A lot of times where things might look under-priced, undervalued, but continue to focus on the long-term. Time is on the side of most endowment and foundation investors.

[00:13:46] When investing over multiple decades, time is a great ally to have. Yeah, it's so important to keep that long-term perspective. So thanks for pointing that out. We really appreciate you joining us today, Matt. I know [00:14:00] that it's been quick, but you've shared so many excellent insights. For folks who want to find out more, access more resources.

[00:14:07] We've got a ton on our website, fiducientadvisors.com. You can check out the insights tab. And from there, you'll be able to access white papers, our blogs, and other episodes of the podcast. So Matt, thank you so much for joining us and we really appreciate it. Thanks Devon. Thanks Bob. And Happy New Year. Thanks so much, Matt, great to have you on the show, and great input.

[00:14:29] And I would say in addition to the great resources that Devon mentioned, if you want an even deeper look at the return and risk expectations that Matt previewed, we have an outstanding capital markets white paper that is not available on our website. It's a roughly 20-page report that walks through our expectations for literally every asset class and includes our rationale.

[00:14:53] You can obtain that by contacting the show email, or simply reach out to Devon or me on LinkedIn. All this will be in the show notes. So [00:15:00] to all you good stewards, thanks for investing time to help your nonprofits prosper. We'll connect with you soon on the next episode. Thank you for listening to the Nonprofit Investment Stewards podcast.

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[00:15:33] Always seek the advice of qualified professionals familiar with your unique circumstances.