DiMeo Schneider & Associates, L.L.C.

DiMeo Schneider & Associates, Nonprofit Investment Stewards Podcast
Episode 9, January 13, 2020

2021 Investment Outlook for Endowments & Foundations — With Matt Rice

[00:00:00] Welcome to Non-profit Investment Stewards with Bob DiMeo and Devon Francis from DiMeo Schneider and Associates. 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.

[00:00:27] Now onto the show. Hello, welcome to 2021. And welcome back to the Nonprofit Investment Stewards podcast. I'm Bob DiMeo. As always, joined by co-host Devon Francis. Today, we have a subject that should be top of mind for anyone who oversees endowment or foundation portfolios. As you know, investments pretty much across the board delivered surprisingly strong results last year.

[00:00:56] So, what can we expect from stocks, bonds, and other investments going [00:01:00] forward? Are we perhaps in a bubble that might burst? And will prudent diversification finally pay off in 2021? We're about to get into all of that and more with an authority, but he's much more than that. He's a friend and an amazing colleague.

[00:01:18] Let's first turn to our cohost. Devon, how are you today? And what are your thoughts on this episode? Bob. I am excellent. I'm so happy to have turned the page to the 2021 calendar and just looking forward to the future. So happy to hear from Matt today. Matt Rice is DiMeo Schneider's chief investment officer and he is with us to talk about our updated capital market assumptions and what we might expect from markets going forward.

[00:01:47] Matt has a ton of responsibility here at the firm. He directs the firm's capital markets, the investment strategy, the asset allocation modeling efforts and the alternative investments efforts. [00:02:00] So he wears many hats at the firm and we keep him very busy. He also writes a lot and he's co-authored two books.

[00:02:07] One of which is the practical guide to managing non-profit assets. Obviously, that's applicable to everyone listening today and he has so many credentials. It's, it's tough to list them all, but some sampling are that he is a CFA charter holder and he's also a graduate of Northwestern university. So Matt, great to have you on the show.

[00:02:27] Welcome. Thanks Devon. It's great to be here. Matt. We are so pleased to have you on this show today. Especially setting things up for the new year, but before we dig in on what investment committees and others might expect from their endowments, tell us how you went from being a star defensive lineman playing in the Rose bowl, tackling 230-pound running backs to then becoming so passionate about investing and helping others invest?

[00:02:57] Well, uh, the game of football is [00:03:00] actually has a lot in common with investing. Football is all about preparation, study, risk-reward, and trying to explore your advantages while mitigating your weaknesses. If you don't have a plan, you don't prepare and you don't effectively, work effectively with your teammates.

[00:03:15] You're not going to win many games. I think the same is true on the investment front. Well, Matt, uh, I have to say, I still watch some of the old reruns from your days at Northwestern and they

are great. I see highlights or clips featured at points, but I'm certainly glad that you crossed the bridge and, and, and came to lead us on the investment front.

[00:03:35] I will say before we get into the meat of things, that's probably as good a time as any to provide a short disclaimer of sorts. None of what is shared on the show represents a specific investment recommendation and one thing we know for sure is that forecasts are just estimates and that actual performance will differ.

[00:03:51] It's always a good idea for investors to speak directly to advisors for specific recommendations. So Matt, I [00:04:00] know that today we're here to talk about our capital market assumptions and that's certainly very important, but before we jump into the exact numbers and what committees might need to take into consideration, as they look at their investments.

[00:04:13] Let's start with the framework that DiMeo Schneider uses around asset allocation and forecasting. Can you share with listeners how often we update our capital market assumptions and what are we looking at as we build those assumptions beyond just the expected returns? Yeah. Well, that's a great question, Devon.

[00:04:32] Uh, typically, we, we employ a ten-year outlook with our capital market assumptions. The reason we use ten-year numbers, we think that it gives us some time for mean reversion to play out when it comes to shorter than 10-year periods. Now the market can, can really, uh, trend and revert very, very quickly.

[00:04:50] And there's a lot of noise baked into those numbers. The reason we don't really look beyond 20 or 30 years is, you know, a lot of us really don't know what the world's going to look [00:05:00] like in 10, 20 years, so it gets a little bit dicey in that regard. First and foremost, we typically revise our capital market assumptions on an annual basis.

[00:05:08] Of course. 2020 is, it was a little bit of a unique year because we had put together a plan in, in January of 2000 and by March and April of, of 2020, the world looked very, very different. And so, what we did is we revised our capital market assumptions this year in April. By the time we got to July again, the market looks very, looked very, very different.

[00:05:32] Typically within a one-quarter, one-month period, you're not seeing meaningful shifts in ten-year capital market forecast, but when you have 20 plus percent swings in markets occurring in the short period of time, you know, we, we thought it was important to, to really sharpen our pencils and look at the world as it was April 1st and try to factor in the impacts of COVID.

[00:05:56] And, and what would happen to asset classes. The market, [00:06:00] the markets, particularly, I mean, while the equity markets were down significantly at the end of March, probably the biggest shifts occurred, uh, within the fixed income markets is interest rates really came down dramatically. And then in terms of our process, Matt, can you talk about, is it just you making these decisions?

[00:06:17] Obviously I know the answer to this question, but listeners don't. What’s our process and our methodology around developing these capital market assumptions? Yeah, well, we, we actually began this process in, in 2003. It was the first time we did this and, and, you know, over time we've, we've refined it.

[00:06:36] *The only rule I have is when it comes to building out our assumptions, let's keep using our, our capital market assumptions and our process until we find a better one.* Over the years, we've refined what we've done. We, we found things that we think are, are, are better, and really every year we're trying to find a better way of doing it.

[00:06:54] I mean, that's really the only rule I employ, but there's a lot of folks on our team who are involved in this [00:07:00] process, our investment committee, our capital markets team. Some of our research staff who, who are extremely talented. So, it's really a team effort.

[00:07:11] I think the, I have the luxury now of as opposed to 17 or so years ago that we have a lot, a lot more, a lot smarter people on our team than me. It's a, it's a great luxury to have. So Matt, I think investment committee members are eager to get an understanding of how their endowments, foundations and so on might perform. Maybe if we start high level and you can just share perhaps what your punchline responses to where stocks and bonds are headed over the coming years. As Yogi Berra said, forecasting is tough when it involves the future, but we did have about a decade ago, we did our ten-year capital market forecast for US fixed income.

[00:07:53] We had a 3.7% return forecast. 10 years later, it was, it was pretty much exactly a [00:08:00] 3.7% return. So, I'm, I'm going to call that skill instead of luck. But typically, we have errors. But when we look at the next 10 years, when we look at core US fixed income, we're at 1.2% within just core US investment grade fixed income. 10 years ago, we were at a 3.7.

[00:08:19] Now we're at a 1.2. Bonds are a little bit easier than, than stocks when it comes to forecasting. Because if you know what the interest rate is, you know, what the duration is. And you know, if there's not a default, you got a pretty good idea of what your holding period return will be. When we look at the landscape over the next 10 years, we're, we're in a challenging environment, particularly for, for fixed income.

[00:08:42] And then on top of that, we look at really the, the, just call it US equities. We're in the mid fives in terms of the US return, US ten-year, or I'm sorry for US equities on a 10% return. We have US all cap at a 5.5% return forecast, which is our lowest ten-year [00:09:00] forecast we've had since, since we began the process in 2003.

[00:09:04] So we're, it's a challenging environment. We are somewhat elevated in terms of equity valuations, particularly in the US, from a fixed income perspective. Forward looking returns aren't that attractive. And, and, and from a credit spread perspective, we're much back, much closer now to a normal type of credit spread environment within high yield and so on and so forth.

[00:09:28] We do see perhaps little bit higher returns overseas. I know we've been in a prolonged period where really the US equity market has dominated, but we're looking at international emerging, and we're seeing returns in the, in the seven to eight and a half percent return respectably between those two.

[00:09:44] So we think global diversification is going to continue to pay off as it, as it really did during the, the fourth quarter of 2020. We think that trend is going to continue. So, the basic punchline is expectations are muted compared to where we were last year or [00:10:00] couple years ago? Yeah, they are. And there's to a certain extent.

[00:10:05] I'm sure Bob has mentioned the three levers we look at. Every portfolio has inflows, outflows and a required rate of return associated with it. And, and it's time to, I think it's a good time, if you haven't done that exercise lately, to look at it because there's when it comes to on a go forward basis.

[00:10:24] How do you, how do you kind of live in a lower return environment? Well, is now the time to really just go a hundred percent equities, probably not, if you're looking for a well-diversified portfolio. But on the other hand, if you haven't explored other asset classes, I think our clients have been invested in private equity for many, many years.

[00:10:43] And I think a lot of clients on the, on the endowment side that, that haven't considered that in the past, but it is an area where we think you can get closer to the traditional eight to 9% type of returns associated with it. So, I think really *exploring different strategies than perhaps you've [00:11:00] been comfortable in the past, comfortable with in the past, would be something that I think a lot of, uh, non-profit investment committees ought to be looking at.*

[00:11:09] Matt, I appreciate you mentioning the three levers. And I recall many times, right, when we'll begin working with a client and we'll talk to the investment committee. And I used to have folks laugh when I would say this, but they don't anymore because there's been so much volatility over the past, uh, 10 or 15 years, but I would say, Hey, you're not a financial institution.

[00:11:31] You're, you're a university or you're a hospital or religious order, whatever the case may be. And if you could achieve your investment objectives, your financial objectives, uh, investing in treasury bills, you should, and again, people used to chuckle, but now they understand that, Hey, when we are attempting to advance our mission, whatever that may be, health-related or religious or, or education, or what have you, we are really out to take the [00:12:00] minimum amount of risk required that would help us achieve our goals.

[00:12:03] Before we get into some of the portfolio structure and so on. Can you just talk a little bit about risk? I know the ten-year forecast includes return assumptions, but what's happening on the risk front relative to the past? Yeah, that's a great question, Bob. I think, I think if we look out over the next three to six months, we're going to be in an elevated risk environment.

[00:12:25] I, I don't think I'm, I I'm probably disagreeing with anybody out there. There's, there's really a high degree of economic uncertainty at this moment. And as Bob knows, when, when, when the cope, when the pandemic first broke out and, in March, I began doing a, what I call a daily COVID-19 briefing.

[00:12:45] And it wasn't based on, obviously you can't, you can't measure human suffering in percentages and, and things like that. But it was, it was predicated on trying to understand how the pandemic would impact the economy and how it would impact markets, what it would [00:13:00] do from a volatility perspective. And unfortunately, I've continued to do that daily, on a daily basis because.

[00:13:07] Really, I think volatility particularly in the next three to six months is going to be tied hand in glove with, with the pandemic. While now there's a lot of optimism, the vaccines coming online, we still have ways to go. A vaccine sitting on a shelf, it's going to have no positive impact on, uh, the economy. What's important is getting those shots in the arms and the logistics of it, you know, might be comparable to putting a man on the moon.

[00:13:37] And it's something that is going to take some time to get there. But I expect really, you know, we had, uh, uh, after the, the dip, I think we hit close to 15% unemployment. We've now cut that, uh, uh, close to, or cut that a little bit over a half down to 6.7, but we begin to see that unemployment rate reduction decelerate [00:14:00] with really what's going on in the pandemic at the moment, seeing rising cases, really the market is priced in at the end of 2020 in the, in particular, really the, Hey we're coming to an end of this.

[00:14:11] And I think there could be some complications to the expectations going forward. So, I would just expect really enhanced volatility, really over the next three and perhaps even six months, as you know, we hope everything goes as planned. There could be a bumpy ride on the way. So that's the short-term picture, Matt, uh, of volatility.

[00:14:32] And I certainly think as you indicated, you're not alone in expecting some enhanced volatility over the next three to six months. What about when we look at our capital market assumptions? I know that we build in volatility expectations. Are those expectations markedly different from where they were a year ago, two years ago?

[00:14:53] Uh, they're really not because the way we look at volatility is in addition to the volatility numbers, we [00:15:00] also look at the fat tails. And what do I mean by fat tails? Your typical, if you look back at the S and P 500 volatility over the last 80 plus years, the 37% decline like we saw in 2008 would be one in 1700-year event.

[00:15:16] And, and then if you look back, we've had many periods in the last, you know, 50 years that, uh, that have been more severe than that. We had the .com bubble that was, you know, more severe than that, that type of drawdown. So, you know, really what we do is we really look at the tails of investments and we've, the *one thing we know for certain is that volatility is volatile.*

[00:15:38] It goes up and it goes down. If you just building in kind of naive traditional volatility assumptions, you're really missing a good chunk of the story. So, you know, built into our, our, our, uh, risk modeling and built into our asset allocation, we don't just factor in volatility. We factor in really the, the extreme events that, that kind of [00:16:00] come out of the blue.

[00:16:01] If we take it back to maybe the portfolio level and help investment committee members and other stakeholders with endowments and foundations think about this, you're saying that basically over the next 10 years on large US stocks, which have been the darlings, right for a decade plus. But that, Hey, we're only looking for maybe five and a half percent return per year on average.

[00:16:23] And that's an over-under bet in our modeling, right? We know it'll be wrong, but that's like a 50% probability of it being higher or lower than five and a half percent. But anyway, if large cap US stocks would be high, five and a half percent, and if core fixed income might be, particularly looking at the 10-year treasury, one and a half percent or less, how are you thinking about adding alternatives and what role they might play?

[00:16:48] And just how investment committees might think about allocating their portfolios to give them a fighting chance of achieving their goals, particularly because many of them have spending [00:17:00] policies they're trying to support. Yeah, well, it's challenging. I think within the fixed income world, I think we have to rethink a little bit of what we've been doing from being heavily allocated to a traditional, call it Barclays aggregate bond type of index strategy.

[00:17:15] You're looking more at dynamic strategies that, that have the ability where we're really, we need to look for ways to find more alpha within the fixed income, because at the end of the day, it's really hard to build a diversified portfolio without any fixed income in a portfolio associated with.

[00:17:31] Within the equity side, I think it's a combination of really maintaining a global posture. So not betting too heavily on the, on, on US equity markets. You know, I've been through enough cycles where I've seen decades, you know, I think it was the decade that US equities were negative. We had, the same decade, we had doubled digit returns in emerging market.

[00:17:51] You know, you've seen seeing these ebbs and flows. So, I think maintaining the international diversification, particularly within the emerging market space, we think that [00:18:00] there's a lot of ability to add returns on a risk adjusted, approved risk adjusted basis doing that. I think within the alternative space, you know, we look at the real assets, we think within broad real asset strategies, real estate, and really, real assets.

[00:18:15] We think that, you know, given the, you know, what we saw in, in 2020, I mean, we came into, we came out of 2019 with a $1 trillion deficit. We're now sitting in 2020 at a, yeah, I think right around a three and a half trillion, an actual three and a half trillion-dollar deficit. On top of that, we have the fed really buying mortgage-backed securities and treasuries to the tune of 120 billion, a 120 billion a month.

[00:18:42] And so a lot of the new debt that's being issued to finance the deficit is coming from really the, the fed is, is buying a lot of the treasury securities and it's kind of a monetization of the debt to a certain degree. So, we think there is some while we don't see it really in the next 12 months, we do think longer term, [00:19:00] some of the seeds for inflation are being planted.

[00:19:02] And that's why we really, we do commit a sleeve of, of client portfolios to the real assets. We think the assets that, that have, that can outperform in periods of unanticipated volatility, I'm sorry, unanticipated inflation. So, so that's, I mean the inflection point on inflation is impossible. When it hits, it usually hits fast and, and a lot of people don't see it coming.

[00:19:24] But we think that really some of the, so far, I think a lot of the inflation that we've seen has been more in the financial assets. So, a lot of the monetary policy, the loose monetary policy is basically, you know, pushed up asset valuations. I mean, that's really what the fed is trying to do. It's trying to drive down interest rates and in order to kind of force folks to take more risk and invest to get returns.

[00:19:46] And so we think the fed has been, um, you know, has created a little bit of a, a bubble might not be the right word, but from a valuation going forward, really a lower return environment. And then on top of that, we think that really, as I mentioned before, that the [00:20:00] private equity is an area where I think, I think if you do it correctly, you can, you can add considerable alpha there.

[00:20:06] If you, if you invest in the right strategies and you have a plan and you, you build out a pacing model and you have the liquidity, you have low liquidity needs or modest liquidity needs. I think that can be an area that can meaningfully contribute to returns. But, you know, I mean, it isn't an uphill battle.

[00:20:23] I mean, this, this is a difficult environment to, to, to kind of return targets compared to, uh, perhaps a decade ago or, or two decades ago. There's no way getting around it. It's going to require rethinking a lot of the things that, that, uh, folks have been used to doing, uh, perhaps in the historical environment.

[00:20:42] So I think what I'm hearing you say is that the old 70/30 model to achieve that four or 5% real return is not going to work anymore. I mean, it's going to be challenging, but I think that there's a little bit of a silver lining is that inflation is still reasonably [00:21:00] low. So, if we look back through other historical periods, you know, were normal, and I remember when a 3% inflation was relatively normal and 3% plus, and of course I've got a lot of, I was born in 1974 during the oil embargo.

[00:21:15] So of course my father and father-in-law talked to me about the 1970s and the early 1980s inflation running a double digit. If there's a silver lining so far, anyway, that inflation has been fairly modest and we expect that to be for, for, for quite some time. Although we do think there is some tail risk out there a few years.

[00:21:38] So if we think about that old 70/30 model and take our expectations, look into the future and think about how a portfolio might be, might evolve to be appropriately positioned to achieve that four to 5% real return. What do you think instead of a 30% bond allocation, maybe you have a [00:22:00] 15 to 20% bond allocation with the remainder going to hedge funds where previously there hadn't been hedge fund exposure?

[00:22:06] Is that the type of shift that you, you, you might see for some of our clients? Yeah, I think that, I mean, where the hedge funds we think can, can add the most value is, you know, they're not a replacement for fixed income, but they, they, they can complement it. So, a skillful hedge fund manager right now, our ten-year forecast is in the 5.4% range while it's certainly not, you know, hedge funds are not fixed income.

[00:22:29] We do think that one way you can diversify and, and pick up some returns is sort of investing in, in, in, in a portfolio of diversified hedge fund managers that are, that are, that are skillful. Of course. You know, hedge funds and private equity are both things that you can't just passively invest in. You don't want to just own the average hedge fund.

[00:22:47] You don't want to just own the, the average private equity fund. So, you really need to find managers that, that have, uh, uh, compelling, uh, alpha stories. Matt, can you [00:23:00] touch a bit on a couple of more specific items? And we've already mentioned how large cap US stocks have been the darlings and, and frankly, that's unlikely to repeat itself.

[00:23:13] We've almost never seen, this is a really extended period of time, but you've never seen a particular sub-sector or class just outperform indefinitely. With that in mind, love to get your thoughts on value versus growth, right? Value has been trounced by growth for a decade plus, and then on active investing versus passive investing and where we might think about how that makes sense and where that makes sense.

[00:23:43] *Yeah. I think I've lived through three cycles now where one was, you should always own growth. And then the other was. You should always own value. And then the next one is you should always own growth. I think we see where it's heading the next time. I mean, no style [00:24:00] grows to heaven. It just, it just doesn't. There's mean reversion, it will happen. If we look now, I think that the value growth divide is as high as it's ever been.*

[00:24:08] It's even eclipsed the late nineties. And you know, the problem with trying to time the styles is that I remember back in thinking in 1997, 1998, that growth stocks were hugely over-valued and they were, the problem is it took till the early of 2000, you know, early part of 2000 before, I mean, reversion plays out.

[00:24:28] So, I do think for, for those investors that, that, that have value styles, and I know our clients do, we typically diversify between growth and value, that certainly now is not the time to, to abandon your value styles. When it comes to active versus passive, we believe in both. I mean, there are certain, you know, the way we look at is really on a, a grid where within, uh, within, uh, the active value landscape, there's kind of the ability to add alpha really on the vertical [00:25:00] side of the graph.

[00:25:01] And on the horizontal, we, uh, we look at the ease and difficulty of replicating any particular index. You know, there are certain indexes that are extraordinarily easy to replicate. The, I don't want to offend folks at Vanguard or Fidelity or whatever, but Vanguard 500 fund is pretty commoditized.

[00:25:18] It's really largely about expense, but if you, if you're, an S and P 500 fund can pretty reasonably predictably capture the S and P 500 index return. But when you get into some fixed income strategies, on the other hand, even some passively managed strategies, oftentimes the, the index funds can, can underperform within the fixed income.

[00:25:39] I remember back in 2002, I don't want to pick, pick on the mutual fund company, but they were managing a bond index fund and, and of course they, they didn't want to own all five to 10,000 holdings or whatever it was at that time, uh, 15 or plus years ago, but they decided to get their energy

holdings and their telecom [00:26:00] holdings through Enron and WorldCom and they weighted those.

[00:26:03] So that index fund ended up underperforming its index by close to 2% in 2002. So, there are certain categories that are easier to replicate passively, others that are more difficult to replicate passively. So that's one dimension and then the other dimension is, you know, there's, there's probably no more liquid place in the market than US equities.

[00:26:25] There's also every single stock, large cap stock in particular within the US equity market is covered by a litany of analysts. It's very, very difficult, we think, for somebody to have a sustainable advantage within the large cap space. There's just a lot of competition.

[00:26:41] I go back to my playing days from a football perspective, you know, there were certain weeks we had to play Ohio state. And it was, you know, typical week. You want to split the double team and make the play and be a star. And then some weeks you're better off just making a pile and letting your linebacker make the play.

[00:26:58] And that's what [00:27:00] large cap equities is, it's really hard to split the double team there from an active management perspective, but there are some other categories that we think that there's, um, significant ability for skillful managers, areas that aren't as covered, that aren't as liquid, whether it be high yield fixed income or, or, or other categories where we think active management makes the most sense.

[00:27:21] Matt. This is terrific. And this is so insightful for committee members and other stakeholders. I've jotted a few notes. I'll call them takeaway notes as I've listened to you. And one is, expect lower returns in all likelihood, across many, if not all asset classes and categories going forward, that diversification is probably as important now, as it's ever been.

[00:27:44] I liked your line about, uh, you know, no style or one asset class grows to heaven. So lower returns, diversification is as important as ever, to have a blend of value and growth, and then to thoughtfully use both active and [00:28:00] passive index strategy. So that's just super, thank you, Matt. Absolutely. Bob. You have been so insightful and it's been great to have you on the show.

[00:28:09] We, I think could talk to you all day long. Uh, we don't want to keep our listeners prisoned for too long. So, we always like to close the podcast out with a couple personal questions. We like to know more about you as a person. We already heard a little bit about your illustrious football career. I assume you don't still play football.

[00:28:29] So what do you enjoy doing outside of work? Uh, when we're not keeping you too busy. My six-year-old daughter and my nine-year-old son are running me ragged. I don't know if they're aging me or they're keeping me young. I'm not, I'm not sure, but if there is a silver lining to the pandemic, I certainly have gotten to spend a lot more time with them.

[00:28:49] And so, uh, there aren't very many silver linings to the pandemic, but spending more time with my family, it has been fantastic. And also, we, we just, uh, we're finishing up [00:29:00] here, the college football season. So, I've been spending a lot of time, uh, enjoying that even with the, all the uncertainties that this unique year brought to that.

[00:29:10] That's great. Well, we really appreciate again, having you on. Thank you for all of your insights. You know, we look forward to what the coming year will bring. Great. Thank you so much for having me. Matt. Thanks so much. It was just absolutely terrific and a special thanks to our listeners. Remember to subscribe and rate the show and please do visit our research and insight section on the

DiMeo Schneider website, where you'll see a number of pieces that Matt and many of his colleagues publish.

[00:29:37] And you can sign up for our 2021 capital markets white paper, which either was just released or will be released shortly, depending on when you're listening to this episode. Always you can reach out to me or Devon on LinkedIn. And so, to all you good stewards, thanks so much for investing your time to help your nonprofits prosper.

[00:29:57] We'll connect with you soon on the next episode. [00:30:00] Thank you for listening to the Nonprofit Investment Stewards podcast. Click the subscribe button below to be notified of new episodes and visit dimeoschneider.com for more information. The information covered and posted represents the views and opinions of the guests and does not necessarily represent the views or opinions of DiMeo Schneider and Associates.

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