Fiducient Advisors, Nonprofit Investment Stewards Podcast
Episode 54, December 7, 2022

Four Action Items To Combat Market Volatility and Uncertainty

[00:00:00] Welcome to Nonprofit 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 and welcome back to the Non-Profit Investment Stewards podcast. I'm Bob DiMeo, and it's certainly good to be joined by co-host Devon Francis. We think today's episode will be super helpful and timely for investment committee and board members, and quite frankly, anyone who has anything to do with overseeing investments. It's just me and Devon and the show will be shorter than usual, but with all the volatility and uncertainty in both the markets and the world.

[00:00:57] We think listeners will appreciate the four considerations [00:01:00] we lay out. You could even call them action items for good stewards. First things first, Devon, how are you and what are your thoughts about tackling a number of issues that are really concerning to investors these days? I'm doing great, Bob. It's great to talk to you as always.

[00:01:15] I'm really excited about today's show because as you mentioned, there's a lot of uncertainty out there and it feels like investors are just getting more and more anxious. So I'm really hopeful that some of the topics that we address today might help provide some immediate benefit or provide some comfort or, you know, to just make folks feel a little bit better.

[00:01:36] So with that said, let's get right into it. And the first topic is of course, you know, looking back, it's been a really rocky year for investors. So, can you share some thoughts on how those who oversee investments might avoid letting emotions get the best of them? Yeah, that's a great question. And these markets have certainly not been for the faint of heart.

[00:01:59] [00:02:00] Uh, I think we have to remember that investors are human and it's understandable that these volatile markets can be very concerning especially when how your endowment or your foundation performs, that often ties right back to your organization and to your nonprofit's mission.

[00:02:19] So some perspective on why being concerned or even nervous is understandable. If you look at the past year, it's been historical in the depth and the breadth of falling prices. And what do we mean by that? It just hasn't been stocks that have gotten hammered, but bonds down big, real estate down big and so on. And as of this recording, a balanced portfolio, think of the old 60/40 stock to bond blend.

[00:02:47] It's on track for about its worst performance in 80 years. And then treasury bonds right now are on track for their worst performance in 200 years. So, what can [00:03:00] committee members do about that? I think there are actually a number of things. I mentioned the tie to mission, and most of our listeners, they oversee endowments or foundations that support nonprofits with very long term, or in many cases, even in perpetuity time horizons.

[00:03:18] And when you go back and you think of some troubled times in the past, think of the tech bubble, think of the great recession, think of the pounding that stocks took at the beginning of the pandemic in 2020. These and many other bear markets are absolutely jarring when they occurred, but they all passed and history tells us that the current downturn will also pass.

[00:03:42] So I, I think part of this is simply being emotionally disciplined. If you have this in perpetuity time horizon or a very long-term time horizon, committees and boards, they must compel themselves to block out the day-to-day noise and the volatility. [00:04:00] In fact, I, I'll be just a little bit bold here and, and challenge listeners that the next time they hear or read a negative report, maybe it's some geopolitical event.

[00:04:09] Tech company layoffs or whatever, ask yourself if, given that you oversee a very long-term portfolio that supports a very long term non-profit mission, is this event that you just saw someone talk about or that you read about, as bad or as unpleasant as it may be, is it noise or is it news when it comes to making decisions about your portfolio?

[00:04:36] I think when we pause and we ask ourselves, is this report noise or news? It really puts things in perspective and we realize that many, many more times than not, it's noise as it relates to our mission. It's not fun and it's not productive. It's not good to get hung up on the noise. So I think managing emotions and [00:05:00] expectations, that's absolutely part of it.

[00:05:01] But there's more. We encourage our clients to strive for a clinical approach. We've talked about three levers on this show before. Pretty much every organization, every nonprofit and beyond, has three levers. What are your inflows? What are your outflows? What are your required returns? So, it's as good a time as any to go back and revisit your three levers.

[00:05:24] And if you sort of assign or assume normal or reasonable return expectations on the portfolio, and that doesn't get you to where you need to be with respect to your mission, it means you have to tinker with the other levers. Maybe you have to do more on the revenue side or do more on the fundraising side, or maybe you need to make some tough decisions with respect to expenses, but revisiting the three levers, taking in almost clinical approach certainly can help.

[00:05:54] But you can control even more, and that's controlling what you can control. So things like [00:06:00] expenses. Certainly in this environment, it's important to revisit the expense structure. Underlying managers, all the professionals you're working with. And speaking of professionals, I would say it's a really good time to think about the advisor that you're working with.

[00:06:13] Do they instill confidence in the committee? Are they helping you think about things beyond just the portfolio and how the portfolio and its returns and performance ultimately tied to mission in the organization? And it's even a good time to think about the constitution of your committees and your boards, and frankly, there's more, but I think probably more will come out as we chat.

[00:06:36] Devon. Thanks, Bob. And you know, I would say just one other thing to point out is perhaps, uh, maintaining a focus on governance. So we have our fiduciary governance calendar that all of our, our clients are familiar with, but it goes back to controlling what you can control. So you can’t control the markets.

[00:06:57] You can't control what, uh, you know, what [00:07:00] returns are going to be, uh, a month over month or year over year basis. But you can control the fact that your committee is paying attention to the things that matter. So, making sure that your investment policy statement is sound and, and provides a good blueprint for, um, managing the endowment.

[00:07:17] You can control fees and expenses as you said. You can control, um, the behaviors of the investment committee in the board. So, I think that paying attention to governance is really important. And, you know, if you think about folks that are prone to seasickness, what the advice that they always get is look at the horizon.

[00:07:36] So don't look off the side of the boat at the waves. Look ahead at the, at the flat horizon. And I think that's great advice in this tumultuous environment that we have right now. To your point, don't pay attention to the noise. Don't look at the, you know, day over day dips. Look at the fact that you have a perpetual time horizon and you know, just keep your eye on that long term [00:08:00] prize.

[00:08:00] And I think that's sound advice. That's great additional input, Devon, and, and frankly, as you mentioned, fiduciary governance calendar. You're having me think about, uh, spending policy, right? Also a great time with these volatile markets, with drawdowns on endowments and such to be thinking about the spending policy and do you, do you have the right methodology in place?

[00:08:20] And that's a whole other discussion. Uh, and we actually have a, uh, podcast episode on that as well. So, so that leads to number two. And Devon, I would ask how should endowment and foundation leaders think about returns on their investments on a go forward basis? Well, I think it's pretty clear that the 10 plus years of free money, thanks to very low interest rates, are clearly behind us.

[00:08:45] So, investors I think need to appreciate that these low interest rates created a TINA environment. Tina stands for, there is no alternative. So fixed income was not appealing. It was, you know, equities are [00:09:00] bust. And the very low interest rates also enabled a lot of borrowing and leverage, which further drove up stock prices, particularly here in the US.

[00:09:09] So we've had, uh, an environment of really strong equity returns. If we look over the last 10 years and take a look at those 10-year annualized results, the S&P has a return in the double digits up, you know, between 11 and 12%. Of course, it depends on when you're listening to this episode.

[00:09:33] But, um, but that 10-year, you know, year over year, the S&P has returned more than 10 percentage points per year, whereas the aggregate index fixed income has returned less than 1%. International markets only about 3%. Emerging markets only about 1%. So, there's been a huge dispersion between returns that US markets have delivered, US equity [00:10:00] markets, and basically everything else.

[00:10:02] And given the volatility that we've had over the past year, um, now that's had an impact on, uh, some of the three-year results. For instance, the aggregate index or international markets both developed and emerging are looking at negative three-year results. So, it's been, it's been a really interesting environment where diversification has not been a benefit.

[00:10:27] When we look forward, are we likely to see another 10-year period where large cap domestic equities produce double digit returns over that 10-year period? Probably not. If I was a betting person, I would, I would guess that the answer was no, but return expectations looking forward for bonds are much higher than they have been because, uh, given the fact that interest rates have moved so substantially and are now at higher levels now, bonds are actually, uh, generating positive real returns, which has not been the case [00:11:00] for several years.

[00:11:01] International return expectations are higher, particularly EM, the strength of the dollar has been a real headwind for international markets. Historically, currency leadership tends to be cyclical, so we don't expect that the dollar strength will, uh, you know, continue in perpetuity. So, you know, I think, uh, I think diversification is something to pay attention to.

[00:11:22] And frankly, while they've been a bit of a punching bag over the last decade. Hedge funds might actually be one of those categories with higher expected returns on a go forward basis. So really, it gets back in part to what you mentioned earlier, Bob, about the three levers, inflows, outflows, and required returns.

[00:11:42] What asset allocation decisions should you be making to help meet your required return? Is the portfolio profile that you've had in place for the last several years, given forward looking expectation, does that portfolio profile remain appropriate or should you be making adjustments? And then to your [00:12:00] earlier point, are there other levers you can pull?

[00:12:02] Reduced spending, being more thoughtful about expenses, thinking about increasing those inflows based on revenues or fundraising. So, I'll just underscore some of what you already shared. It's all about perspective, and I think that it's important for folks to not get caught up in the volatility that we've seen over the past year.

[00:12:23] Bear markets happen about every six years, and when they do happen, they tend to last, on average, about 14 months with a drawdown of about 33%. But bull markets tend to be much longer, tend to last almost six years with a cumulative return of over 260%. So, you need to weather the downturns in order to take advantage of the upturns.

[00:12:48] And you know, we've all seen the data, I guess, uh, which, which shows the impact of missing only a handful of the market's best days. And the important thing to take away from that is that many of the market's best days [00:13:00] tend to happen during bear markets. So, the importance of remaining invested, again, keeping that long term time horizon in mind, uh, I think is really important in this environment.

[00:13:15] So, Bob, let's shift to some specifics and let's talk about portfolio implications. What should committees consider in order to improve returns? And how do you think diversification and exposure to alternative investments might be helpful? Yeah, well you alluded to it, Devon, that diversification plays an important role.

[00:13:38] And I guess the punchline would be now is not a time to sleep on diversification, if you will. And if you take the large cap US stocks versus foreign stock scenario that you were describing so much created a tailwind for US stocks over the past decade. Plus these low interest rates, they benefit growth stocks and the US is a clear [00:14:00] leader in tech.

[00:14:00] So that worked. And then so did the strong dollar. So did the work from home environment, and you can go on and on. And I'll share an interesting and somewhat nuance perspective regarding low rates and how they benefited. Uh, not only venture capital but us as consumers. And, and if you take a look, we know that low rates moved many investors to risk assets.

[00:14:24] As you described earlier, the TINA effect, and a lot of money to venture capital, and that led to companies like Uber having piles of cash with one main goal, add revenue. They don't care about profits. Let's just capture market share, add revenue. And the piles of cash led to an ability to provide subsidies to customers.

[00:14:44] So for example, a ride that should be a $20 Uber ride, actually was, was costing us $12 as a consumer. Well, that's no longer the case. And higher interest rates have obviously [00:15:00] dinged the venture capital space, but also us as consumers when we were benefiting from cheap share rides and cheap music streaming services and that sort of thing.

[00:15:10] And where am I going with this? All, all of this is really to say that as an investor, you were not penalized for a lack of diversification in your portfolio, and that went on for years. In fact, you were not only not penalized, you were rewarded for not diversifying. The best thing you could have done for many, many years was buy US growth stocks.

[00:15:31] But we at Fiducient, we believe in patterns and cycles, uh, that have been prevalent in investing for years. And if you take this US versus foreign stocks, which you alluded to, it's typical to have a handful of years when one outperforms the other, and then it swings back. And you sort of see this over, over many, many decades.

[00:15:51] But US stocks have dominated for a lot longer this run than normal. But when we do look at things like lower [00:16:00] valuations of foreign stocks compared to the US counterparts, or that foreign stocks generally have higher dividend yields, or that the US dollar is not likely to continue its dominance forever.

[00:16:11] Uh, the support for diversification makes sense to us over the long haul. And frankly, it's not just foreign developed, it's emerging market and as you mentioned, hedge funds and other spaces. Of course, probably as good a time as any to, uh, to mention that none of this is a recommendation to listeners.

[00:16:27] Uh, we of course encourage folks to examine their own portfolio and reach out to professionals like ourselves or similar firms. But we do believe in diversification and that would play an important role in portfolios on a go forward basis. So, Bob, staying on this topic for just a moment, you mentioned venture and the wind having been behind its back with very low interest rates.

[00:16:52] Now that we're in a higher rate environment, should investors avoid asset classes or alternatives like venture, [00:17:00] like private equity, real estate, other areas? So, the short answer is no. In constructing portfolios, selfishly, we desire as broad a universe to choose from as possible when we're building a broad and thoughtfully diversified portfolio.

[00:17:16] We just want the biggest set of tools, if you will, uh, to help a university, a hospital, a museum advance its mission. And when you consider an asset class like private equity, it's worth noting that the number of publicly traded companies has shrunk by thousands over the years, so you don't even have the same opportunity set that you did.

[00:17:36] Just 15 or 20 years ago, in terms of investing in companies, if you're not considering privately held companies as well. But it's also good to mention, and we can be emphatic about this, that when it comes to alternatives, be it private equity venture, hedge funds, private real estate, what have you, your approach or your game plan and your diligence that's performed is perhaps as [00:18:00] important as it's ever been.

[00:18:02] We would say like on the macro level, this means eyes wide open. Understand the opportunities and the risks, including liquidity or illiquidity and that sort of thing. And then the strategy around what you should allocate to private equity, venture capital, real estate, and so on. And what are your pacing models to get from your current allocations to your desired levels?

[00:18:26] While maintaining quality and, and, and that kind of thing. So, what kind of diligence is being performed to give yourself the best likelihood of success? Um, you, you can take, for example, look at private real estate. Are you accessing managers that are perhaps successfully pivoting from commercial office space to data warehousing and that kind of thing?

[00:18:49] And when done properly, there's an entire process regarding alternatives that we believe takes investment committees and boards even from awareness and understanding [00:19:00] to comfort, to implementation, and remember the tie to your mission. None of us roll out of beds saying, wouldn't it be great to invest in more expensive, less liquid, less transparent types of like, no one wants that, but when you look, getting back to your earlier point about lower return expectations, we think that alternatives will play an important role going forward to achieve the returns that organizations need to achieve to advance their mission.

[00:19:30] But boy, you definitely want an eyes wide open approach.

[00:19:36] So, Devon, lots of talks, some good, some bad, over the past year about socially responsible investing, DEI initiatives, and the like, what's the lay of the land and what can or should investment committees be thinking about on that front? It's been really interesting to see the headlines shift over the course of the year.

[00:19:55] So coming into 2022, all of the headlines were, you know, [00:20:00] ESG is here to stay. And I do feel like in strong markets, investors have, uh, what might be considered the luxury of being able to focus on perhaps more aspirational things like aligning their assets with their values. As the 2022 market decline continued, we saw less of a focus on ESG, quite frankly, because I think investors were just trying not to panic.

[00:20:25] And the articles that were published were very often skewed negative. So, as we know, uh, at least through the first nine months of the year, energy was really the only positive area of the market. So, many environmental focused ESG strategies lagged due to lack of exposure to oil and gas. So, there was a lot of finger pointing, and the headlines were, you know, ESG strategies lag in down markets,

[00:20:50] And so just like anything, I think it's so important to keep things in perspective. And quite frankly, you can slice and dice the data any way you want in order to [00:21:00] make your favorite argument. So, let's say you're an ESG naysayer. You can point at 2022 returns and say ESG strategies lagged.

[00:21:09] In other time periods, ESG strategies outperformed. And of course, it really matters what criteria you're using. There are ESG strategies that are focused on the E. There are ESG strategies that are exclusionary in nature. So, it's, I really think it's unfair to broadly say, uh, ESG outperforms or ESG underperforms. But what's interesting is that there have been many, many studies that have been done, and over the long run, research has shown that incorporating ESG factors does not mean sacrificing performance.

[00:21:43] So I think that's important to, to keep in mind. What is really important when a client comes to us and expresses interest in pursuing some sort of ESG approach? What is really important is the why. If [00:22:00] you're thinking about incorporating an ESG approach, why are you doing it? Is it just because you think other institutions are, because you're reading all those headlines and you don't wanna be left behind?

[00:22:10] Is it pressure from stakeholders, whether that's, you know, students or faculty for a university, constituents, donors, someone involved, uh, in the organization? Is it peer pressure from those folks? Is it because you truly feel that it's important for your assets to be aligned with your values?

[00:22:31] So when a client comes to us and says that they're interested in pursuing ESG investing or mission-aligned investing, however you want to designate it, we embark upon a four-step process. And the first step is define. That first step can often stop a committee in its tracks. When we ask them, define what your values are and the driving force behind wanting to pursue [00:23:00] this path. If you can't articulate the organization's values or the reasons for pursuing an ESG or MAI approach, it's prudent to take a pause and figure that out before you take any next steps.

[00:23:13] So, uh, you know, there's one client that I work with, it's one of my, my dearest clients, I love working with them. And, um, they're like children, right? We don't have a favorite but, and, uh, they came kind of out of the blue. Uh, I had signed off of an investment committee meeting. I had gone through the report, we were, my section was done, and then the executive director called me afterwards and said, well, out of the blue, after you were off the line, the committee said that they want to pursue ESG.

[00:23:47] And I said, oh, okay. What do they mean by that? And she said, I don't know. And I don't think they know. And so, we scheduled an educational session and really talked about that why, [00:24:00] and no one on the committee was able to articulate it. And when people did articulate specific ideas, they were very different.

[00:24:06] So some folks were interested in an environmental approach, some folks were interested more on the governance side. So, there wasn't really an overarching objective that they were able to put their finger on. We did is we, um, created an ESG summary report where we looked at all of their underlying portfolio strategies, and went through and said, okay, these managers are employing the following processes.

[00:24:36] And one of the things that was clearest from undertaking this exercise is that about three quarters of their managers were using ESG integration, where ESG criteria was a part of the investment process in selecting underlying companies. So, once we talked through some of the approaches that the underlying investment managers [00:25:00] in this client's portfolio were taking, they felt comfortable. Oh, you know, our managers are already kind of taking care of this for us.

[00:25:07] We don't need to be really heavy handed and say, okay, this is our ESG approach that we're going to dictate. And they felt much more comfortable after the fact. So, I think, uh, it's important really to take the time in that first step of the process, the define step. And if you can't articulate your values or the reason behind pursuing this, then I think it's, it's important to take a pause.

[00:25:38] Let's say that there is a client that's able to define that and they do want to pursue a more intentional ESG or MAI approach, my advice would be don't let perfect be the enemy of good. Uh, so except that you might not be able to articulate your organization's set of values precisely.

[00:25:57] And furthermore, you may not be able to access, [00:26:00] um, ESG or MAI strategies in every single asset class. So perhaps you can reflect your values in a large cap domestic equity strategy, but you might not be able to do so within hedge funds. Well, overall is, uh, having a diversified portfolio with some risk reduction through, you know, by way of something like a hedge fund is that more important than having that really heavy-handed ESG approach?

[00:26:30] So, I would encourage folks to not take an all or nothing approach. The marketplace is constantly evolving. New strategies are constantly rolling out, and I think that an organization's approach and their portfolio can and should evolve over time. That's great, Devon. Appreciate that input and this session has been fun here.

[00:26:51] I hope, uh, there's something for all of our listeners and that they benefit from it. Anything you'd like to add? No. I would just encourage our listeners to [00:27:00] visit the insights section at fiducient.com. There are so many good white papers, blog posts, and of course additional episodes of this podcast. You know, we're constantly putting out content from the research side, from all areas of the firm.

[00:27:14] So in volatile markets, really knowledge is power and there are so many useful resources. Oh, that's great. Thank you so much, Devon, and many thanks to our listeners as well. If you are someone who oversees an endowment or foundation, and if you have questions or concerns, reach out to us. Uh, the team here at Fiducient can provide what we call an observations and considerations analysis.

[00:27:38] We share insights on your cost structure, your investment performance, the governance, and a whole lot more. It's all free with zero obligation. Uh, we've done this for many years, and many of the folks we've done this for have actually ultimately, uh, ended up becoming clients. If you're interested, reach out to me or Devon through the show email or on LinkedIn, and I'll just say to all you [00:28:00] good stewards, thanks for investing time to help your nonprofits prosper.

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