FIDUCIENT Advisors

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True or False? Answering Key Investment Questions for NonProfit Leaders

[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 Nonprofit Investment Stewards podcast. I'm Bob DiMeo. Always good to be joined by co-host Devon Francis. Devon, how are you today? I'm great, Bob. Good to be back with you and, uh, it's an exciting format. Today, we're trying something a little bit new, so, uh, I'm looking forward to it.

[00:00:49] Absolutely. Well along those lines, a few updates for our listeners. First, praise to our listeners. The show built great momentum last year. In fact, many of the episodes in 2022 were [00:01:00] top 25% of all podcast downloads, and that's great and we've had so many great guests. So, uh, many of the kudos go to our guests who have provided us with such wonderful content and covered so many timely topics.

[00:01:13] So big thank you to them as well. Absolutely. And wanna let folks know that we're evolving to a monthly format. As many listeners know, we had been releasing episodes biweekly, part-time crunch, part trying to maintain really high-quality episodes and great guests. We'll be releasing monthly episodes this year.

[00:01:33] And another exciting change is that we're soon going to be including video format along with the audio content. So that's exciting and more to come on that front. Yep. Folks will be able to put a, uh, face with the voice. So that's great. So, with that background, and again, praise for our listeners, let's jump right to today's topic.

[00:01:53] It's a format we have not used before. We're going to go through a series of true and false statements. That Devon and [00:02:00] I are going to ask one another and we'll sort of be putting each other on the spot, if you will. Yeah. So we're about to tackle a host of questions and topics, and those topics as always are very timely.

[00:02:11] They should be super important and relevant to nonprofit stewards and their leaders. A good chunk will be investment related, but we'll also address some other topics that are pressing for nonprofit leaders. Excellent. So with that, let's get started. Devon, you are one of our resident ESG, SRI, Mission-Aligned Investing experts, if you will, and ESG has gained great momentum.

[00:02:36] But more recently it's had a bit of a hiccup with findings of greenwashing or said another way, funds and managers purporting to invest in an environmentally sound approach, but turns out there's sometimes more talk than walk. So the true or false question is, will ESG continue to grow in its importance in use over the coming five years?

[00:02:56] True or false? In my opinion, that's a [00:03:00] definite true statement, Bob. You're absolutely right. There has been a ton of conflict in this space, a lot of accusations of greenwashing, and probably the most headline grabbing of those was with regard to BlackRock. So Larry Fink is the CEO of BlackRock, and he writes an annual letter to investors and he's been focused for the past several years on sustainability.

[00:03:24] And, you know, hangs his hat on the idea of being a good steward to the environment and so on and so forth. And just recently, there's been a lot of controversy saying that because BlackRock continues to be invested in fossil fuels and investing in companies that are, you know, uh, considered some of the bad actors in the environmental space that he is talking the talk, but not walking the walk.

[00:03:50] And that folks should reduce exposure to BlackRock because of that. Then at the same time, and, and actually these controversies came [00:04:00] up within weeks of each other, you had 19 attorneys general from various states boycotting BlackRock because of their focus on sustainability. So, you have folks from both sides of the aisle being angry at BlackRock, and you know, I give BlackRock because it's a, it's a very obvious example in the investment world and they manage a ton of assets as everyone knows.

[00:04:23] But you know, the controversy bubbles up all around us with regard to, uh, a variety of different firms. A lot of it is political noise. But despite that recent political backlash and accusations of greenwashing and on the other side of the aisle, um, kind of a desire to move away from companies that have an ESG approach, I do really think that ESG is a trend that's here to stay.

[00:06:33] Another thing that I think is going to, uh, add to the traction in the ESG, you know, landscape and interest in ESG investing is the newest DOL ruling. So it went from a Trump era rule that really precluded retirement plan sponsors from offering ESG related funds, where now it's more of a neutral approach.

[00:06:59] So [00:07:00] the rule says that fiduciaries may include consideration of climate change and other ESG criteria as part of their risk return analysis. They're not required to do so, but they can incorporate an ESG approach into their analysis of funds to include in their retirement fund menu. So, I think that this new rule will likely remove a lot of the fear that retirement plan sponsors have had of incorporating ESG strategies into the investment menu.

[00:07:29] So because of that, we may see in retirement plan assets that are invested in ESG strategies. And then finally the last comment that I'll make is that there's a really substantial transfer of wealth going on from an older generation to a younger generation, and a lot more women are coming into wealth and have more sizable assets, uh, than previously.

[00:07:54] Typically, the folks that tend to be more interested in ESG related strategies [00:08:00] are younger investors and female investors. So simply the fact that we have a significant amount of wealth that is changing hands, I think will also increase the adoption of ESG strategies. So very, very long-winded answer, but, uh, you know, just to, to boil it down, true, ESG investing will continue to grow in importance and use over the next five years.

[00:08:24] That sounds like true, true, true. And, and that's super helpful. And it's funny, as you're going through that, I'm thinking, you know, demand matters. And it's not only demand that we see in requests for proposals that we receive, but just the discussion amongst our investment committees, right? When we're working with an endowment or a foundation and sometimes it's, it's, uh, very early on the learning curve.

[00:08:46] And then sometimes it's really nuanced and advanced implementation. But I would say demand is further support. And then additionally, you have measurement, just measurement becoming better all the time in, in numerous areas. And I read [00:09:00] something a while ago that pointed out about accounting standards really not coming into play.

[00:09:05] I think it was until the 1940s. And that's almost hard to fathom that before then, you know, companies are almost doing whatever they want and reporting, you know, sort of core accounting and, and income and balance sheet items. And then you worked over time towards standardization. Of course, we're seeing that ways to go still, but we're seeing that on the ESG and SRI front, so, so.

[00:09:25] Excellent. That's terrific. All right, so Bob, I'm gonna shift the, turn the tables and ask you a question. So, active investing. Active investing will have its stay in the sun in this market environment over passive. True or false? I would say true. I could, I could, uh, it's funny, I could sort of be a politician in my response and say, you know, even a broken clock is right twice a day.

[00:09:48] And, and, and right. You know, active, meaning active will habits turn in the sun and at times passive will habits turn in the sun. And that's why we really invest in both, uh, methodologies, [00:10:00] if you will. And we try to be thoughtful. What asset classes make sense to really be active. Predominantly and most of the time, and what asset classes would we prefer to be passive?

[00:10:10] But getting back to the gist of your question, which is, you know, is active management about to have its turn in the sun? I really think that's going to be the case for a few reasons, and it begins with, we're effectively coming off, or we're clearly off now the decade plus of free money, if you will.

[00:10:30] Listeners can't see my air quotes, but right. We were in an environment where effectively we were in a period where effectively cash was paying nothing or next to nothing, and it was the old TINA and there is no alternative. And the fear of missing out and all of that combined to a real risk on, if you will, setting or environment.

[00:10:53] And it was a tide that was lifting all boats. So, when you think about equities, we had good companies. [00:11:00] And their stocks performing well and we had bad companies and their stocks performing well. And in this sort of setting, skill, you know, if you think of right individuals making decisions that potentially could add value, it just did not matter that much.

[00:11:17] And as I mentioned earlier, we do take a look at both methodologies and we generally implement both methodologies. So generally, if you're thinking, large company, US based companies, that would be more passive strategies for our clients most of the time. But if you think of other categories like, hmm, let's just say emerging market equities where smart people hopefully can make good decisions on companies and countries and currencies and so on and so forth.

[00:11:49] But again, we were in this environment of effectively free money. Low interest rates, little competition, and really the [00:12:00] ability for individuals to add value. I'm talking about active management, not really being able to shine. You also had to compound that extreme performance and impact by a handful of stocks.

[00:12:13] So I think of the FAANG stocks, right? Facebook, Apple, Amazon, Netflix, Google. And while the bloom is absolutely off the Rose. Now on, on many of those companies, if you look back to first quarter of 2022, you had market capitalization for those five companies of over 7 trillion. That's just a staggering sum, and according to Investopedia, if you look back to that time, you've had periods where the S&P 500.

[00:12:48] Again, it's 500 stocks, but these five companies accounted for almost 20% of the market capitalization in the [00:13:00] S&P 500, and at times, almost 40% of its movement in terms of appreciation. And that's according, again, to Investopedia. So free money's over. FAANG stocks have started to wilt. and there's an opportunity, we believe, for smart people to add value.

[00:13:19] So definitely the answer in our view is yes, active managers will have the opportunity for, uh, to have tailwinds at their backs or the sun to shine on them, and it could apply even more in certain asset classes. And, and I'll make my final point being this, that not only are active managers and things, emerging markets and such likely to have the ability to add value on a go forward basis, but some strategies, think marketable alternatives or hedge funds, where free money and sort of market soaring.

[00:13:54] That was not a very favorable environment for hedge fund or [00:14:00] marketable alternative investments. However, if you're in more of a sideways or a down market or a volatile market and the free money's gone, you could see some of these alternatives, which absolutely require active management to, uh, to perform well.

[00:14:17] So, Devon, that actually leads to another true or false question, and, and that would be on international versus domestic equities. And, and the question there being do you expect domestic markets will continue to outperform international markets? No. My answer to that is false. So I do not think that domestic markets will continue to outperform international.

[00:14:40] That's not to say they won't outperform this year or next year, but we don't think that domestic leadership will continue uninterrupted. So why do we like international? First of all, the opportunity set outside the US is very large. It's actually much larger than the opportunity set inside the US borders. [00:15:00] If we look at the MSCI All Country World Index, there are about 2,500 stocks domiciled in the US and over 6,600 domiciled overseas.

[00:15:11] So in terms of the number of investible companies, much higher overseas than in the US, about 72% of listed stocks are domiciled outside the US. 96% of the global population lives outside of the US, so only 4% of people live here domestically, and then we've got 96% overseas. So that would, you know, in and of itself would suggest a wide opportunity set.

[00:15:40] And then finally, 84% of global GDP is produced by foreign companies. So, you know, a big reason why the US has dominated in recent years is because of the sector allocation. So, we are the leaders in the tech industry. About 80% of tech stocks are US based. As you [00:16:00] discussed, Bob, it's been those big FAANG names that have driven a lot of the market performance in recent years.

[00:16:07] As we see a shift away from that very concentrated and narrow tech leadership driving markets, we think that international markets may benefit. And then also currency returns are a major driver of relative performance and we're coming off a period of very significant dollar strength. So, the dollar has really been the currency leader over the past 10, 12 years or so.

[00:16:32] We saw a reversal of that leadership in the fourth quarter of 2022. And international markets outperformed. So just like with everything else, currency leadership tends to be pretty cyclical. We don't think that the US will be, that the US dollar will be the currency leader forever in perpetuity.

[00:16:52] So, at some point that, you know, currency effect should become a tailwind for international markets. And then finally, from [00:17:00] a valuation perspective, international equities look less expensive than US equities, both, uh, relative to their own history and also relative to US stocks. So, we do think that from a valuation perspective, there's some room to grow in the international markets.

[00:17:14] That's not to say the international markets are not without risks, both economic and geopolitical, but we do think that, uh, we should start to see, you know, a period over the coming years where international markets outperform. All right, so Bob, I've got a question for you.

[00:17:34] If investors know the outcome of an important event, they'll always make money. True or false? False. And, and why do I say that? Uh, it's a couple of reasons. One is, first of all, you did say if investors know the outcome, but that's really challenging in and of itself, right? What, what's going to happen in this economic cycle?

[00:17:55] Recession? Not recession? Or give an event around a company or, [00:18:00] or sector or what have you. So, so it's really challenging to get the event right. But even with that, you can have the outcome wrong. And I'll give you a couple of examples. I go back to 2011 when US debt was downgraded and it was a big deal, right?

[00:18:16] It was AAA rated and there was fear about US debt being downgraded. And you know it, there's a pretty good probability it was going to happen and folks had concern about that occurring. And what happened when they actually downgraded the debt? Well, it still remains the safest debt in the world. So as opposed to what you would normally think is people flee something that's downgraded and, and think less, uh, favorably about it actually.

[00:18:46] The turmoil globally created more of a demand, and you actually saw yields drop with respect to US treasuries and such, so folks could have, uh, accurately predicted, yep, the [00:19:00] US debt will be downgraded. But they probably got the outcome wrong. And then I'll give one other example. This was in a, uh, Wall Street Journal article in late December, and they talked about how Wall Street, effectively, if you look at the analysts and so on, nailed the earnings forecast for 2022.

[00:19:23] I think the average analyst forecast for earnings for the S&P 500 that they nailed it within $1 of actual results, at least through late December, and that's the best forecast that they had made since 1995. So, you sit back and you think, okay, so a bunch of analysts are saying, this is what's going to happen to earnings and they're maybe not gonna be as favorable in some instances and so on, and, and they actually nail it.

[00:19:51] They get the earnings forecast right. However, that success was spoiled by the fact that they missed the bear market in stocks and [00:20:00] bonds. And so while they had the earnings forecast, right, they ended up not being the story. The story, as we all know, was inflation and then rate hikes by the Fed. And even though they came through on the earnings front, they missed what that was going to do.

[00:20:16] With respect to stocks and bonds. And so in this instance, it underscores, in our opinion, the need for a balanced portfolio where we talk about the three levers and not always being able to anticipate what's going to happen over the short term. What is an investor's inflows, outflows, what's their required return?

[00:20:38] And because there's uncertainty, and even if you know what might happen with an event, you don't know the actual outcome. It's really great if you can have these broad, thoughtfully diversified portfolios. Some might perform well in high interest rates or low interest rates. Some components might perform well in risk on or risk off environments, but at least give yourself [00:21:00] a fighting chance of achieving your goals, kind of regardless of what's occurring as a result of a given event or outcome.

[00:21:10] So with that, uh, let's come back to you, if we may, Devon. And in this instance, uh, we want to get to a, uh, you know, kind of a hot topic and, and a timely topic, and that's cryptocurrency. And will that become an important part of a diversified portfolio in the coming years? True or false? False. Uh, we do not think that cryptocurrency will ever become an integral part of an endowment portfolio.

[00:21:38] Maybe if you're a speculative investor, your own personal account and you wanna do some day trading, have at it, be my guest. But, uh, in terms of part of, of a well diversified endowment program, we don't think that it's, it's the right investment strategy. And you know, it's interesting, this question was coming, uh, to us [00:22:00] quite a bit.

[00:22:01] Um, at, you know, at the end of 2021 when we had cryptocurrency that were riding high, Bitcoin was down about 60% in 2022. We're not getting this question so much anymore, but you know, it's just, it's really such a speculative area of the market. And it's too volatile. Volatility isn’t inherently bad.

[00:22:24] But if you are going to accept increased volatility in your portfolio, it needs to come with predictable correlation. So you want to add investments that will zig when the rest of your portfolio is zagging. And then if those investments are more volatile, that's okay because they behave differently than the rest of the assets.

[00:22:43] There's essentially no correlation between cryptocurrency and other areas of the market. So, it's completely unpredictable. You don't know how it's going to act in any certain market environment. It's got a very asymmetrical risk-return profile, so you're taking [00:23:00] on a lot of additional risk. You know, it's basically the equivalent of, uh, investing a portion of the endowment in lottery tickets.

[00:23:07] And then furthermore, you know, we are wary of investments with a lack of regulation and transparency. So, there's really no governing body that's overseeing, um, cryptocurrency businesses. So, we just don't think that it makes sense, uh, as part of an endowment program. All right, Bob. So, we don't think, or at least I don't think that cryptocurrency is a good solution for, uh, for endowment assets.

[00:23:32] Let me ask you this question. Innovative ideas and companies ultimately win out and their shares do as well. Is that true or false? False. It's false. And I will actually, I was reading another Wall Street Journal article. This is from January 22nd. And I want to, to, uh, point this out because I think it really underscores the point.

[00:23:53] Uh, it highlighted how individuals have poured more into Tesla in the past six months [00:24:00] than in the past six years combined. Think about that. Individual investors, not institutional. Individual investors invested more over the past six months than over the past six years combined in Tesla. And I'll read a quote from a 41-year-old entrepreneur in California who moved 100% of his equity portfolio into Tesla stock in 2018.

[00:24:22] Last year, he lost his entire seven figure retirement fund because he needed to fund margin loans. But he's not calling it quit, he says, and I quote, there is just no company even remotely close to Tesla in innovation. Why would I invest in a basket of dinosaurs? I assume he's talking about maybe like the S&P 500 there.

[00:24:42] So he's probably right on the innovation statement. I had a chance to listen to Elon Musk in some great detail recently in a, a little bit smaller group. And, and you know, there is definitely brilliance there and the innovation is, is amazing. [00:25:00] But let me repeat the true or false statement. Innovative ideas and companies ultimately win out and their shares do well.

[00:25:08] The reason I'm saying it's false is you actually have example after example over the, like, crypto's innovative and how many folks, just to follow on your, you know, very innovative, but how many people have lost a great amount of money? I remember, this is going back a little ways, but uh, this was kind of, uh, along the lines of the tech bubble in 2000 and leading up to that, I was doing a little bit of homework on bubbles, and I remember reading about electric utility companies, and in the early 1900s.

[00:25:38] That was great innovation, right? Electricity was really just rolling out across the country, and I think many listeners would be shocked to find out that electric utility companies, you know, those boring and, and just sort of stayed entities. They were trading at about a hundred times earnings on average.

[00:25:58] Well, today, [00:26:00] electricity is everywhere. So that wasn't the miss. It was assuming that the investment in utilities would be as wonderful as the innovation. So it's a lesson for our stewards. Begin with the blueprint. What's our investment policy? What's our strategy? And then continually revert back to how a given investment, be it crypto or whatever, might play into and fit with our blueprint or investment policy.

[00:26:29] So with that, we'll, uh, take it to our final True and false, Devon, and I'll ask you, uh, again, a little twist away from investments, but definitely important to and on the minds of nonprofit leaders. Will nonprofit fundraising get back to normal as the, as the impact of the pandemic dies down? True or False?

[00:26:51] False. I don't think anything in the world is going to get back to normal, including nonprofit fundraising. And that's not just an after [00:27:00] effect of the pandemic, but it's just, you know, it's the effect of a changing population. And as I mentioned earlier, there's a significant transfer of wealth. We have a lot of younger people that have more wealth in their hands.

[00:27:14] Those people, in many cases, are very philanthropically inclined. But with the younger generation comes, uh, a different focus. An area of emphasis. People, there's a lot of technology coming to the fundraising world, so whereas it used to be you'd get a solicitation in the mail and you'd take out your checkbook and send in a check.

[00:27:35] That's really not the most common way of giving anymore. It's all app based. It's, it's online based. In many cases, we're seeing subscription programs rather than, you know, a one-time annual gift. Um, so we see a lot of, of shifting dynamics in the fundraising world, and I don't think, uh, that we will ever get back to kind of the old [00:28:00] guard.

[00:28:02] Well, thanks Devon. This has been a lot of fun. A little different format for us, and I've enjoyed it. I hope you did too. Any closing thoughts? No, it definitely was a lot of fun and gives us a chance to talk about some timely issues. So thanks, thanks for suggesting it. So our next episode will be our quarterly quick takes with, uh, one of our favorite guests, Brad Long.

[00:28:21] And again, uh, we will be incorporating the video format to that. So, we hope they're able to, to join us and give that a listen and a look. And a reminder to listeners, if you do have questions or concerns regarding the portfolio that you oversee, please consider us a resource. Reach out to myself or Bob at the email on the show notes or through LinkedIn.

[00:28:44] Excellent. Well, thanks so much, Devon. Again, it was fun. Thanks to our listeners. And 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 [00:29:00] podcast. Click the subscribe button below to be notified of new episodes and visit Fiducientadvisors.com for more information.

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