Mercer

welcome to brighter

Top considerations for endowments and foundations in 2023

Plotting a course through volatile markets

select to navigate back to this page at any time

Executive summary

The past year has ushered in a combination of interconnected challenges for investors, from geopolitical conflicts to high inflation, supply chain problems to financial market volatility.

At the same time, Russia's invasion of Ukraine has shaken equity markets further. Economic sanctions as well as energy and food supply issues have exacerbated investor concerns about inflation, particularly in Europe. Combined with a risk-off approach, global indexes fell by as much as 25% during 2022.

According to Mercer's survey of endowments and foundations (E&Fs), conducted early in 2022, half of respondents cited higher inflation as one of their two main investment challenges for the next three years. This was second only to concerns about low expected investment returns. In addition, 39% said they were not sure or did not believe that their portfolios were prepared for a market downturn.[1]

If your portfolio has experienced investment losses, it is easy to be pessimistic and focus on the worst outcomes. While it is prudent to be prepared for such scenarios and ensure that these short-term headwinds do not affect your organization's overall mission and spending plans, it is also important not to be caught off guard: make sure you are positioned to capitalize on compelling opportunities.

To do this, you will need information — and plenty of it. The path ahead over the coming months and years is unpredictable, and it is best to explore different scenarios and how they may affect your portfolio, its liquidity, and the ability of your investments to support your organization's mission and objectives.

Fiduciaries managing endowment portfolios face four important strategic challenges. In this paper, we introduce approaches to navigate them to achieve long-term success while managing short-term disruptions. Click the icon to navigate to the read more.

1. Adapting to higher inflation and interest rates

2. Keeping your ESG investments on track

3. Seizing opportunities emerging in private markets

4. Capturing long-term trends in public markets

[1] Mercer 2022 Global Not-for-Profit Investment Survey, available at https://www.mercer.com/our-thinking/wealth/global-not-for-profit-survey.html

1. Adapting to higher inflation and interest rates

Capturing emerging opportunities

Inflation across all 38 countries in the OECD ranged between 0% and 3% in the decade ending 2020. By June 2022, this average had risen to 10.3%.[2]

As inflation rises, so do central bank interest rates and bond yields, meaning debt-servicing costs for borrowers — such as governments, households, and corporations — are rising. This has led to a decline in bond prices concurrent with public equities, which are facing their own pressures. Except for private markets (subject to pricing lags), commodities and absolute return strategies, most asset classes experienced significant negative returns during 2022.

Were inflation to remain high for several years, it could pose considerable challenges to E&Fs. Not only would it be difficult to achieve a real return that meets or exceeds annual spending policies and expenses, but it would decrease the odds of maintaining purchasing power (at least in the short term).

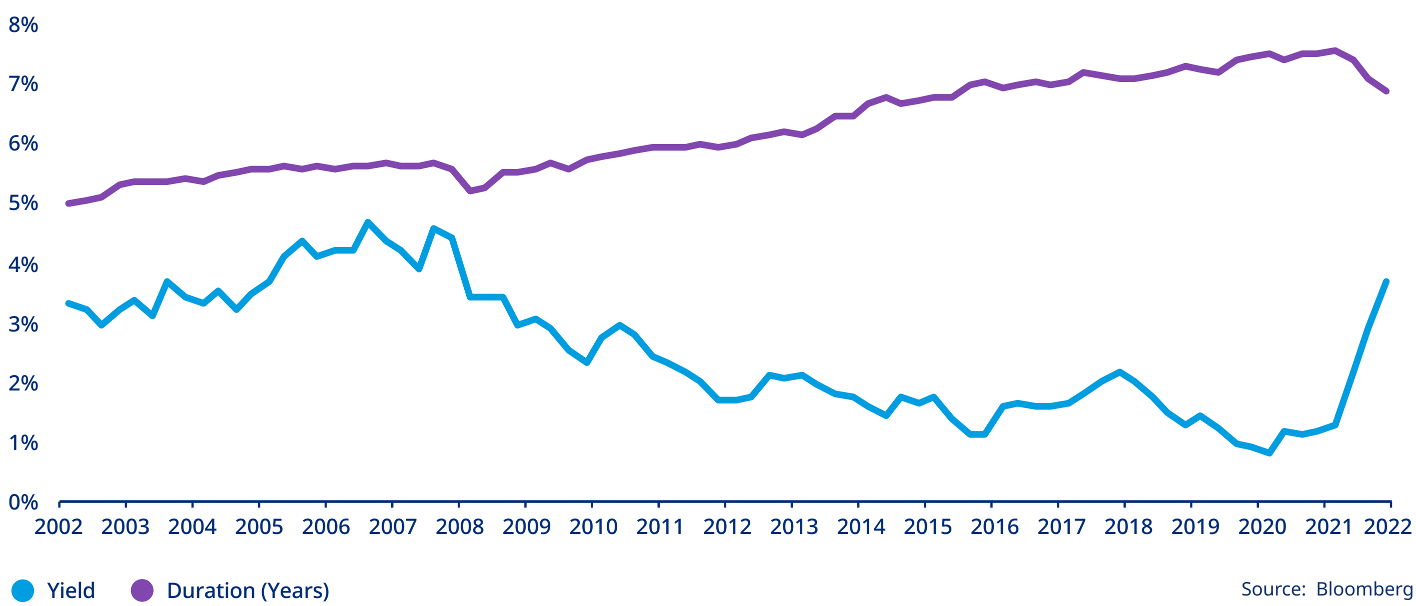
These circumstances bring challenges for investors, but they also bring opportunities — and it is important to identify both to mitigate the first and seize the second.

Diversification is important for all institutional investors. According to our global not-for-profit survey, 61% plan to add to private equity holdings and 53% are targeting real assets such as real estate and infrastructure, which can exhibit inflation protection qualities.[3]

Ultra-low interest rates, which started in the wake of the 2007–09 financial crisis and were exacerbated by the effects of the COVID-19 pandemic, led many investors to diversify away from investment-grade bonds to other, often riskier, asset classes.

Higher yields today are presenting opportunities in fixed income. E&Fs should reassess their asset allocation to ensure that it remains appropriate in light of higher fixed-income yields. It is also worth reviewing the composition of fixed-income portfolios. Additionally, consideration of other strategies that are helpful in high-inflation periods, such as natural resource equities, might be warranted.

Figure 1: Global Bond Market Duration and Yields
(Past 20 years, Bloomberg Aggregate)



Source: Bloomberg

[2] OECD, Statistics News Release, August 3, 2022. Available at https://www.oecd.org/sdd/prices-ppp/consumer-prices-oecd-08-2022.pdf
[3] Mercer 2022 Global Not-for-Profit Investment Survey, available at https://www.mercer.com/our-thinking/wealth/global-not-for-profit-survey.html

Considerations

- **Stress-test your portfolio** to explore the impact of different interest rates and inflation scenarios. By modelling different economic outcomes and the impact they may have on your portfolio, you can assess the ability of your investments to support your organization's goals.
- **Reassess your bond allocation** with a view to understanding at what point you could increase your holdings in government and/or corporate bonds. What role do bonds play in your portfolio? Should this be revised, given shifts in prices and yields?
- **Explore inflation protection options** such as index-linked bonds to hedge rising prices. You can also investigate private market options such as infrastructure, real estate, or some forms of private debt. Natural resource equities could also be considered, assuming they are not in conflict with your organization's risk tolerance and/or ESG beliefs.
- **Review spending plans** in light of current circumstances. Do you need to reduce spending or adjust your investments to support greater spending? Will there be changes in contributions from donors? You can also review how much cash or liquidity you need, and whether you can allocate to illiquid assets to make your money work harder.

2. Keeping your ESG investments on track

How to balance investment returns and philanthropic goals

Market volatility and poor returns in 2022 have prompted many investment committees and boards to review whether they are getting the best financial outcomes from their environmental, social and governance (ESG) related holdings.

In addition, we have seen a growing backlash against ESG investment around the world. In the US, Texas and Florida have even moved to ban asset managers from doing business with state entities if they screen out oil and gas companies.[4]

Greenwashing is making headlines, with some managers receiving criticism that their investment strategies are not as “green” as their marketing claims.

Investment beliefs (and their rationale) are the cornerstones of many E&Fs and are in place in order to meld an institution’s mission with that of its portfolios. Two-thirds (67%) of respondents to our Global Survey said they adopted ESG beliefs to align their investments with their organization’s objectives.[5] Further, we believe this period of turmoil presents a real opportunity for E&Fs to refine their approaches and focus on data- and evidence-led investments.

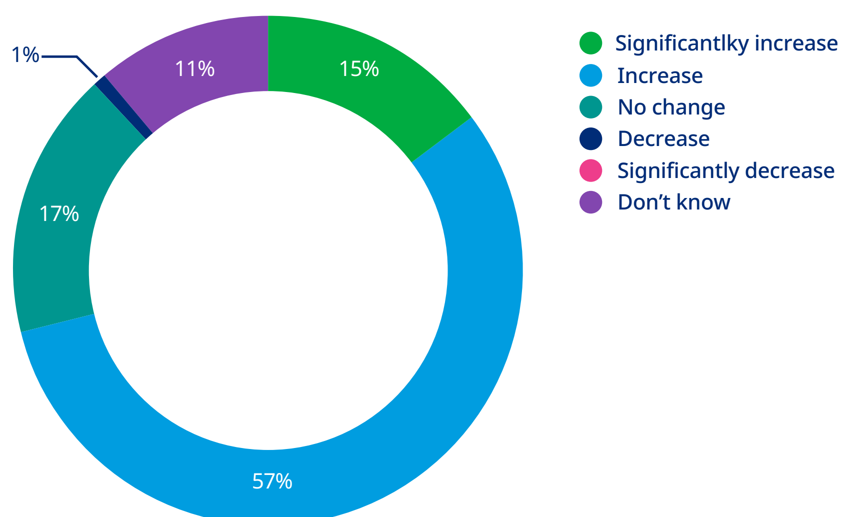
Climate change remains one of the most pressing long-term issues facing our planet. Supporting the goals of the 2015 Paris Agreement on climate change will primarily involve the transition to a low-carbon economy. E&Fs are perfectly positioned to support and benefit from emerging clean energy investment opportunities, however due diligence remains an important part in the process.

Investing in the energy transition is a two-way street. Climate change will have a profound impact on your investment portfolio — but your investment portfolio can also have an impact on the path that climate change will take through investing positively in the transition.

More than half (56%) of survey respondents identified climate change as one of their biggest investment opportunities over the next three years, second to diversifying away from traditional asset classes. Nearly three-quarters (72%) planned to increase or significantly increase their ESG-related investments over the coming 12 months.[6]

A sustainable investment approach may help preserve long-term capital and align your investments with your philanthropic mission.

Figure 2. Cumulative change in US public debt outstanding since start of recession



Source: Mercer 2022 Global Not-for-profit Investment Survey

[4] “The ESG Investing Backlash,” Yahoo! Finance, September 6, 2022. https://finance.yahoo.com/news/esg-investing-backlash-163257538.html
[5] Mercer 2022 Global Not-for-Profit Investment Survey, available at https://www.mercer.com/our-thinking/wealth/global-not-for-profit-survey.html
[6] Ibid

Considerations

- **Engage with your managers** to understand their ESG approaches. While worthwhile, a more “passive” approach that relies on third-party ratings and analysis is less likely to have a direct influence on corporate behaviors or strategies. For long-term investors, an active “hands on” approach can be much more impactful — and could align better with your organization’s goals. By putting tangible, measurable outcomes at the center of your ESG approach, you can hold managers accountable and report to stakeholders on your progress.

- **Explore alignment with your broader objectives.** How could allocating to energy-transition strategies further the aims of your organization? Even if your objectives are not explicitly climate-related, investment opportunities in areas such as sustainable agriculture or infrastructure capture elements of the various layers needed to support the transition. Some ESG-focused asset managers are aligning their investment approaches and strategies with the UN’s Sustainable Development Goals, which can make them well-suited to philanthropic goals and investment portfolios.

- **Capture long-term opportunities** through allocating to energy transition assets in private markets. Investment opportunities to invest into this market while small, are growing. If accessed within private markets, they may allow you to access the premium often linked to private market assets and access to more of the innovation occurring in venture capital companies

- **Model climate scenarios** to understand how different temperature increases will affect your portfolio’s risk over the coming decade. Work with your advisers and asset managers to make sure you have as detailed a picture as possible of your investment portfolio and how it may behave.

3. Seizing opportunities emerging in private markets

The advantage of E&Fs in illiquid assets

We believe there is currently a window of opportunity for E&Fs to invest in capacity-constrained, high-conviction private market managers. Measuring your time horizons in years, and even decades, with limited liquidity requirements, means you can step into the gap that we expect to be left by other investors, such as defined-benefit pension funds.

Many investors will have a set limit on how much they can allocate to private markets as a percentage of their portfolios. For institutional investors such as pension funds, recent asset price movements may mean they are up against or over these limits, necessitating a slowdown or outright stop to capital commitments. They also tend to have much greater liquidity needs than E&Fs and an overarching goal to de-risk portfolios.

This could present opportunities for endowments and foundations that have the willingness and capacity to step in as a provider of capital. Private market managers still need capital to deploy to new investments, especially when markets are in a state of dislocation.

With inflation top of mind for most investors, private markets can also offer a diverse range of assets to protect against rising prices. Infrastructure and real estate often have revenues tied to inflation, while floating-rate private debt can serve as a long-term inflation hedge — and also help to mitigate the impact of public market volatility on your broader portfolio.

Our 2022 Global NFP Investment Survey found that two-thirds (65%) of organizations see diversification away from traditional liquid asset classes as their greatest opportunity over the next three years.[7]

Private markets offer investors access to a vast universe of alternative assets, as well as areas of the economy not usually accessible through public markets, such as ESG-focused investments. With the right approach, E&Fs can also access investments that align with their philanthropic goals, with the potential to make a real-world impact and a financial return.

[7] Footnote note not provided in Word doc

Figure 3.

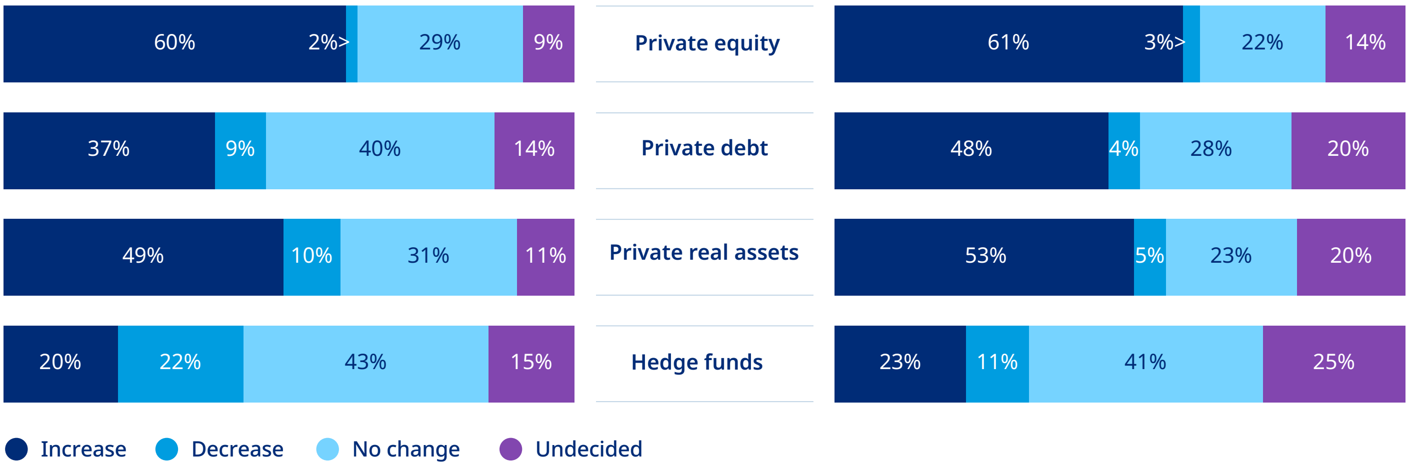
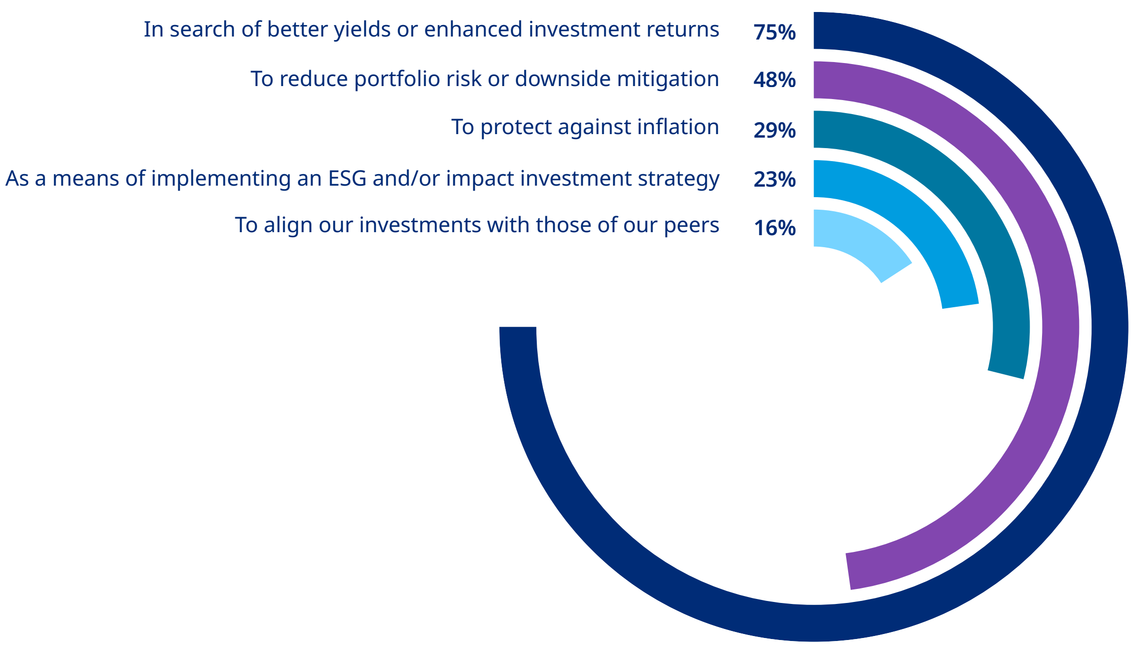


Figure 4.



Source: Mercer 2022 Global Not-for-profit Investment Survey

Considerations

- **Review private market allocations** to ensure your liquidity position remains appropriate. Can you afford to lock more capital away for multiple years to take advantage of the illiquidity premium and investment opportunity?
- **Assess opportunities with best-in-class managers** that may have limited capacity. Leverage your long-term investment horizon to reach top-tier, capacity-constrained managers and strategies at a time when other investors may be retreating.
- **Explore investments that align with your objectives.** Impact investing is a small but growing sub-sector of private markets. Many of these strategies are newer and require strong qualitative due diligence, given limited track records. However, they can be used to better align with philanthropic objectives. How could using the SDGs within your investment strategy benefit your portfolio?
- **Prioritize diversification** by exploring areas of private markets currently not in your portfolio. What qualities might these types of assets bring that you currently do not have? Ensure you have a multi-year investment plan that is robust, fits with your liquidity needs and does not require sudden asset allocation changes to fund.

4. Capturing long-term trends in public markets

Finding opportunities in a volatile environment

Despite the turmoil in public markets in 2022, there remain important long-term themes for E&Fs to consider.

The post-pandemic world already looks quite different than it did a few years ago. Some countries are reversing a decades-long trend of offshoring production, with the US bringing manufacturing back from Asian countries such as China. At the same time, Asian economies are experiencing higher domestic demand from an increasingly wealthy middle-class population.

China remains underrepresented in benchmarks and investor portfolios, given it is home to almost a fifth of the world's population which continues to be a large market that is becoming harder to access via global allocations. As it does so, accessing its onshore equity market through assets known as A-shares should be important for global equity investors in the long term due to the compelling alpha and diversification potential.. A client's allocation to China will be dependent on risk tolerance, both in terms of market volatility and geopolitical concerns.

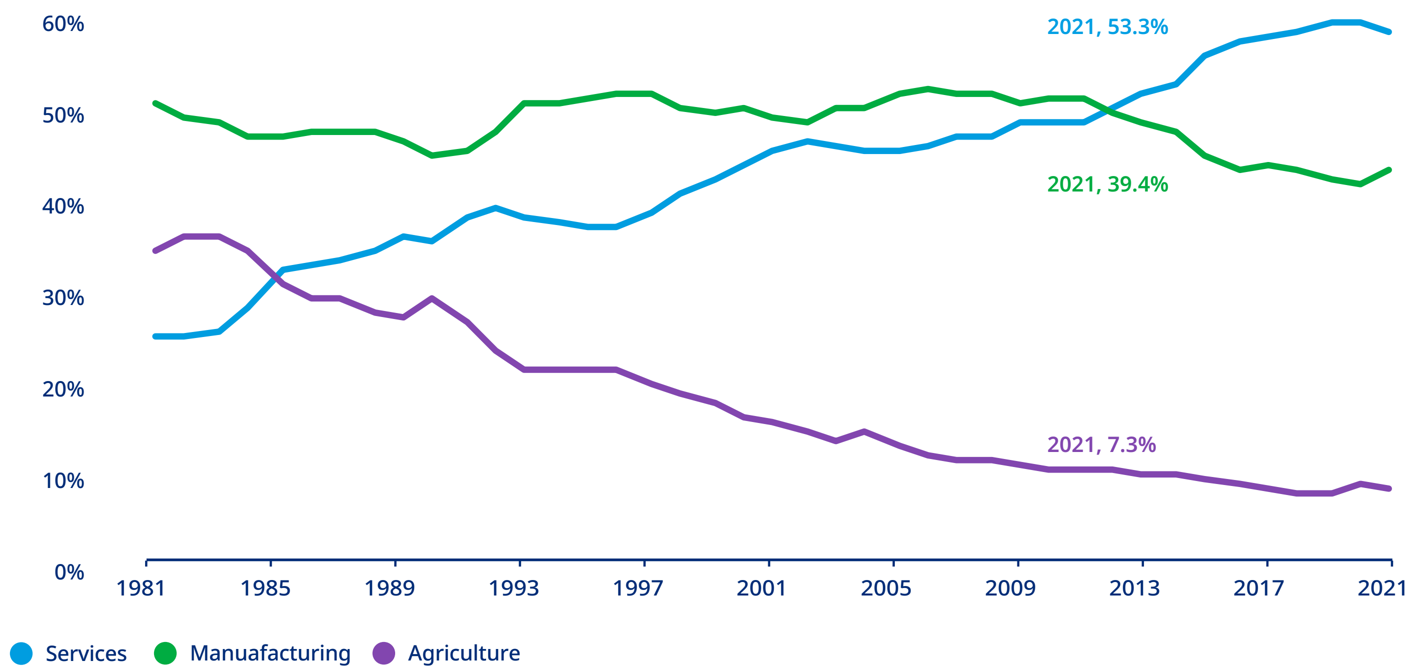
Currently Mercer recommends an overweight to the value investment style within equities based on fundamentals, valuation and still negative sentiment. Longer term, there may be opportunities within the growth style as the technology and consumer discretionary sectors – key growth sectors - have been hit hard by rising interest rates. Should interest rates decline again, growth stocks may benefit.

Some respondents to our investment survey cited demographics and technology as key investment opportunities in the next three years.[8] These remain important long-term trends that stand to have a profound impact on economies over the next several decades.

As we have seen in the past 12 months, geopolitical risk can affect listed markets in extreme ways. While E&Fs are fundamentally long-term investors, you should ensure that your public market exposures do not remain too static and can adapt to capture long-term opportunities. This will require your global equity portfolios to be flexible and less benchmark-constrained to access these opportunities at a good price.

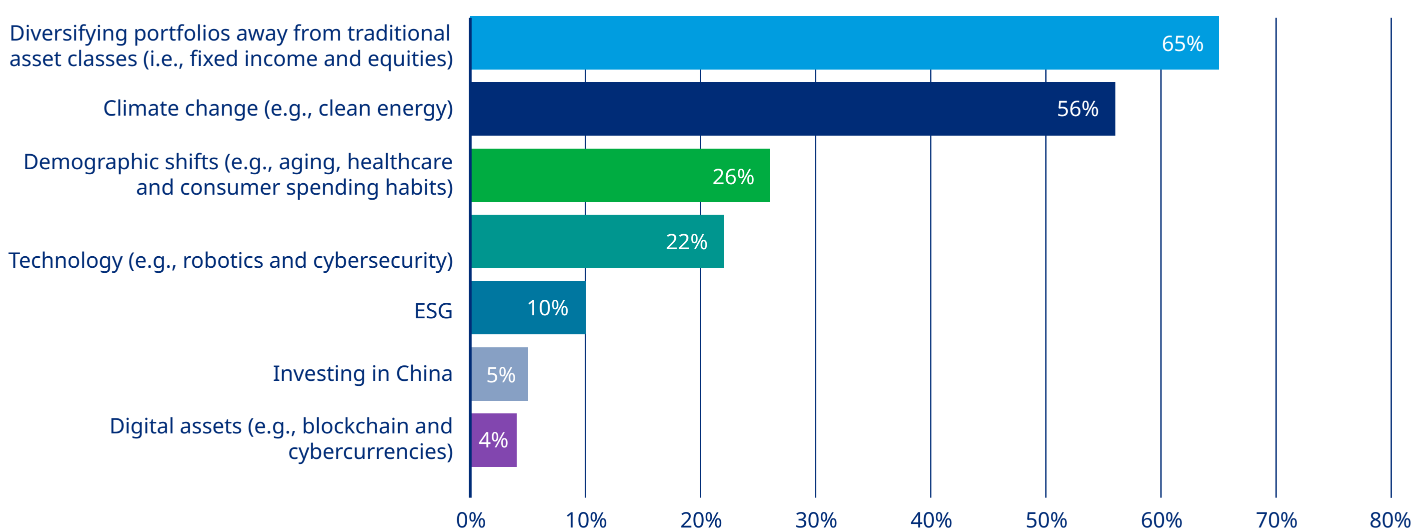
[8] Mercer 2022 Global Not-for-Profit Investment Survey, available at https://www.mercer.com/our-thinking/wealth/global-not-for-profit-survey.

Figure 5. Shift in drivers of China's GDP

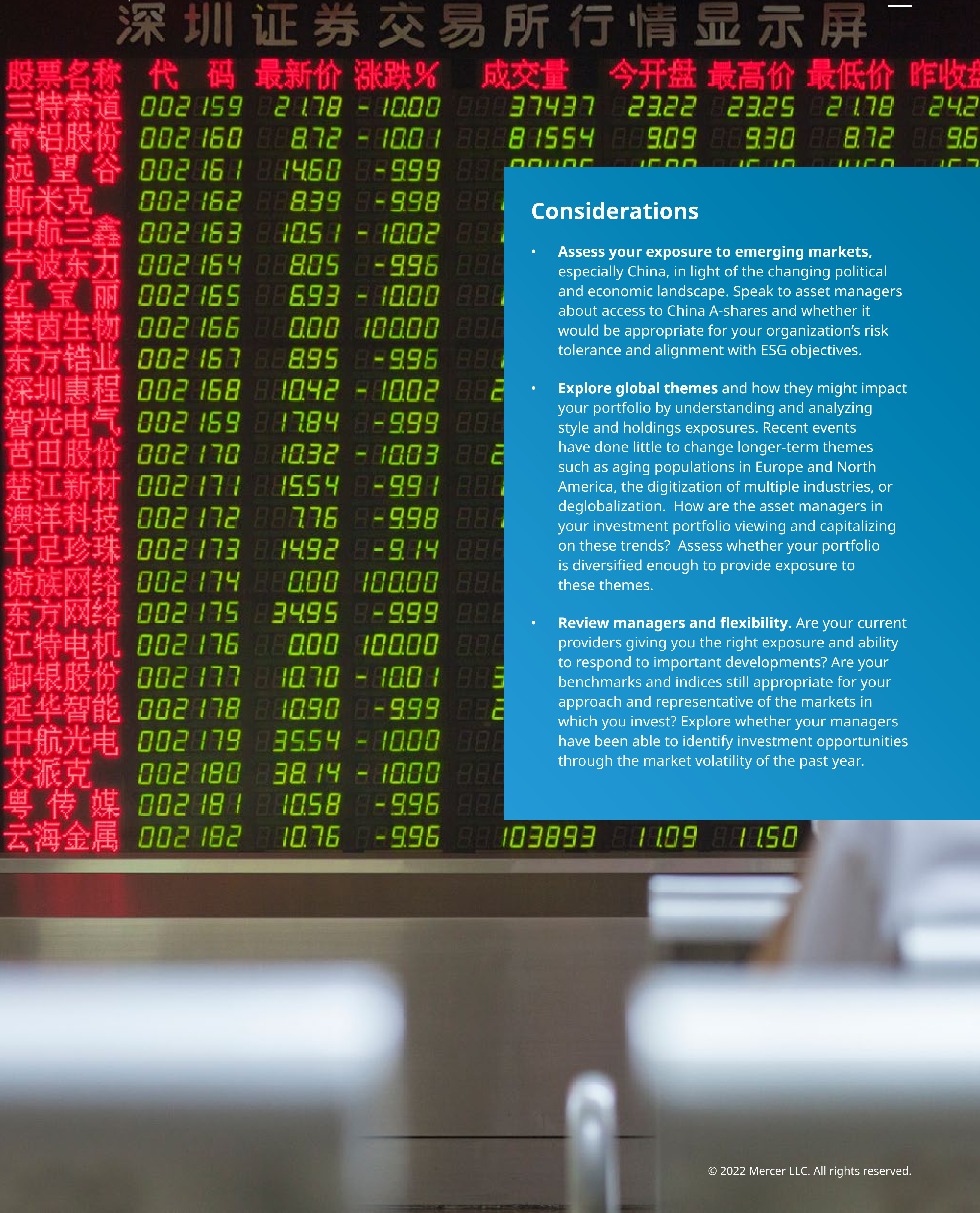


Source: Bloomberg

Figure 6. What, in your view, are your organisation's two main investment opportunities over the next three years?



Source: Mercer 2022 Global Not-for-profit Investment Survey



Considerations

- **Assess your exposure to emerging markets,** especially China, in light of the changing political and economic landscape. Speak to asset managers about access to China A-shares and whether it would be appropriate for your organization's risk tolerance and alignment with ESG objectives.

- **Explore global themes** and how they might impact your portfolio by understanding and analyzing style and holdings exposures. Recent events have done little to change longer-term themes such as aging populations in Europe and North America, the digitization of multiple industries, or deglobalization. How are the asset managers in your investment portfolio viewing and capitalizing on these trends? Assess whether your portfolio is diversified enough to provide exposure to these themes.

- **Review managers and flexibility.** Are your current providers giving you the right exposure and ability to respond to important developments? Are your benchmarks and indices still appropriate for your approach and representative of the markets in which you invest? Explore whether your managers have been able to identify investment opportunities through the market volatility of the past year.

Conclusion

Keeping it all in perspective

E&F portfolios are generally designed and invested for the long term and should be able to withstand periods of market turmoil. Despite the magnitude of this year's events, organizations should maintain focus on their objectives and long-term strategy.

That said, crises often create opportunities for those prepared to capture them. Today, higher inflation, higher interest rates and the growing importance of the energy transition are significant long-term shifts that may warrant a re-assessment of asset-allocation strategies with an eye toward opportunities that can be accessed through public and private markets.

Additional resources

Mercer 2022 Not-for-profit Survey

Themes & Opportunities 2023 - Déjà New

Private markets themes and opportunities - inflation playbook

Private markets themes and opportunities - Positioning for transition

Private markets themes and opportunities - modern diversification

Managing a hedge fund allocation - what is the recipe for success

Systematic Macro hedge funds: Trending into a new regime

Advancing the the transition - seeking to mitigate risk and drive adaptation

Advancing transition potential: Global asset manager survey results

Yield Point℠ blog series

Critical thinking, critical issues℠ podcast series

If you would like to discuss the findings within this report in more detail or how we may be able to support your organization, please feel free to contact your local Endowment and Foundation team representative.

Alternatively, visit www.mercer.com/not-for-profit

Texas Hemmaplardh
US
+1 212 345 0713
texas.hemmaplardh@mercer.com

Amit Popat
Europe and IMETA
+44 7789 030712
Amit.popat@mercer.com

Gilles Lavole
Canada
+1 514 841 7583
giles.lavole@mercer.com

Yaser Z. AbuShaban
United Arab Emirates
+971 56 5248696
yaser.abushaban@mercer.com

Paul Fleming
UK
+44 207 178 3373
paul.fleming@mercer.com

Rebekah Dunn
Pacific
+61 2 8864 6889
rebekah.dunn @mercer.com

Janet Li
Asia
+852 6117 2997
janet.li@mercer.com

Mark Longbottom
New Zeland
+64 21 963 764
mark.longbottom@mercer.com

Important notices

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications.

This does not constitute an offer to purchase or sell any securities.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see http://www.mercer.com/conflictsofinterest.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances. Mercer provides recommendations based on the particular client's circumstances, investment objectives and needs. As such, investment results will vary and actual results may differ materially.

Information contained herein may have been obtained from a range of third-party sources. Although the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

Private funds are intended for sophisticated investors only who are accredited investors or qualified purchasers. Funds of private capital funds are speculative and involve a high degree of risk. Private capital fund managers have total authority over the private capital funds. The use of a single advisor applying similar strategies could mean lack of diversification and, consequentially, higher risk. Funds of private capital funds are not liquid and require investors to commit to funding capital calls over a period of several years; any default on a capital call may result in substantial penalties and/or legal action. An investor could lose all or a substantial amount of his or her investment. There are restrictions on transferring interests in private capital funds. Funds of private capital funds' fees and expenses may offset private capital funds' profits.

Funds of private capital funds are not required to provide periodic pricing or valuation information to investors. Funds of private capital funds may involve complex tax structures and delays in distributing important tax information. Funds of private capital funds are not subject to the same regulatory requirements as mutual funds. Fund offering may only be made through a Private Placement Memorandum (PPM).

Not all services mentioned are available in all jurisdictions. Please contact your Mercer representative for more information.

Expected Return: Actual performance may be lower or higher than the performance data quoted. Actual statistics may be lower or higher than the statistics quoted. The expectations for the modelled portfolio are a compilation of return, volatility, and correlation expectations of the underlying asset classes.

Portfolio expectations are forward looking and reflective of Mercer's Capital Market Assumptions, as defined by asset class and incorporating return, standard deviation, and correlations. Our process for setting asset class expected returns begins with developing an estimate of the long term normal level of economic growth and inflation. From these two key assumptions, we develop an estimate for corporate earnings growth and the natural level of interest rates. From these values, we can then determine the expected long term return of the core asset classes, equity and government bonds. We combine current valuations with our expectations for long term normal valuations and incorporate a reversion to normal valuations over a period of up to five years. Volatility and correlation assumptions are based more directly on historical experience except in cases in which the market environment has clearly changed. Manager impact on performance is not incorporated into expectations. The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future returns.

Certain regulated services in Europe are provided by Mercer Global Investments Europe Limited and Mercer Limited." as per the Marketing Guide.

Mercer Global Investments Europe Limited and Mercer Limited are regulated by the Central Bank of Ireland under the European Union (Markets in Financial Instruments) Regulation 2017, as an investment firm. Registered officer: Charlotte House, Charlemont Street, Dublin 2, Ireland. Registered in Ireland No. 416688. Mercer Limited is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 984275. Registered Office: 1 Tower Place West, Tower Place, London EC3R 5BU.

Investment management services for Canadian investors are provided by Mercer Global Investments Canada Limited. Investment consulting services for Canadian investors are provided by Mercer (Canada) Limited.