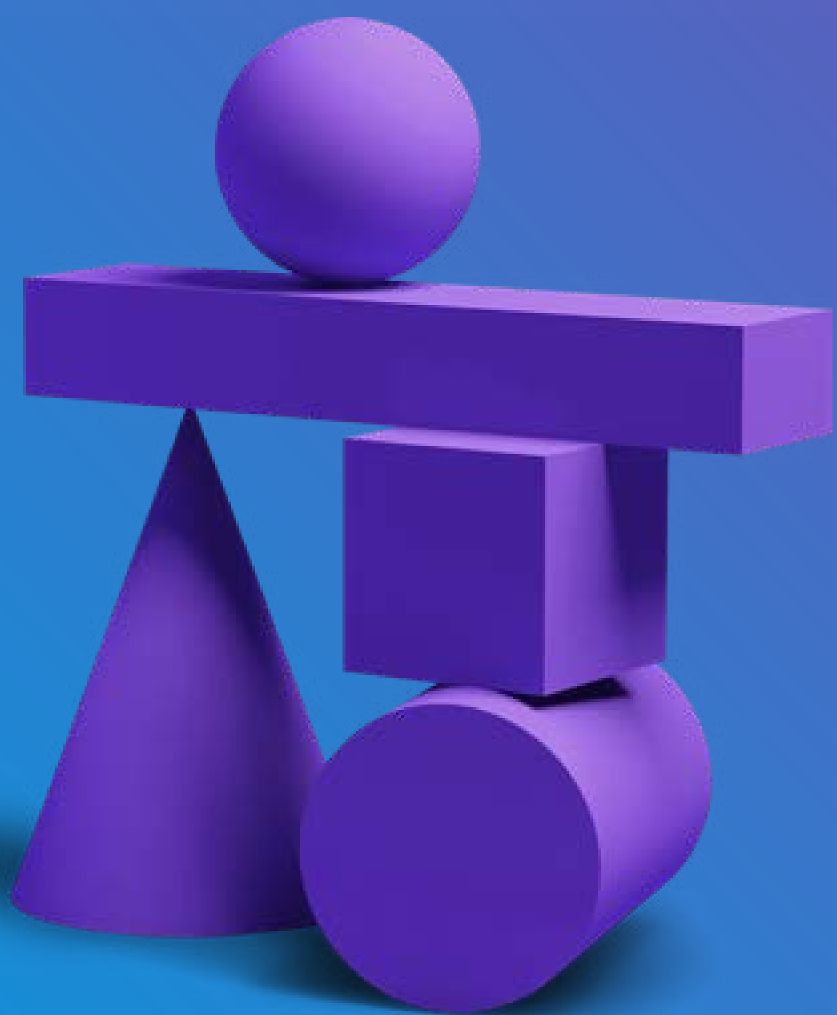
MERCER

Pavilion
A Mercer practice

Top investment ideas for endowments and foundations

2021



welcome to brighter

Intergenerational equity is often described as a tug-of-war between supporting mission in perpetuity and satisfying current needs. But a seesaw might be the more appropriate description: In times of growth, investors look to the horizon and position their portfolio for strategic success over decades.

But in times of market stress, investors focus on short-term mission spending. In recognition of these dual concerns, we grouped this year's *Top Investment Ideas for Endowments and Foundations* into two complementary themes: enterprise and investments. We include short- and long-term considerations for each idea.

Enterprise

Pivot to the "S" in ESG

Mission-driven organizations have historically been at the vanguard of responsible investment (RI), recognizing early that RI considerations are a prerequisite for potential success rather than a concession. The social reckoning of 2020 has added the "S" in "ESG" (environmental, social, governance) to the environmental priorities of the recent past, with a focus on diversity and inclusion (D&I).

Short-term considerations: Seek to ensure that your D&I approach flows from institution through to portfolio implementation.

Long-term considerations: Remember that it's E, S *and* G — not E or S or G. A robust RI approach captures all three elements in a portfolio.

Spend some now, save some for later

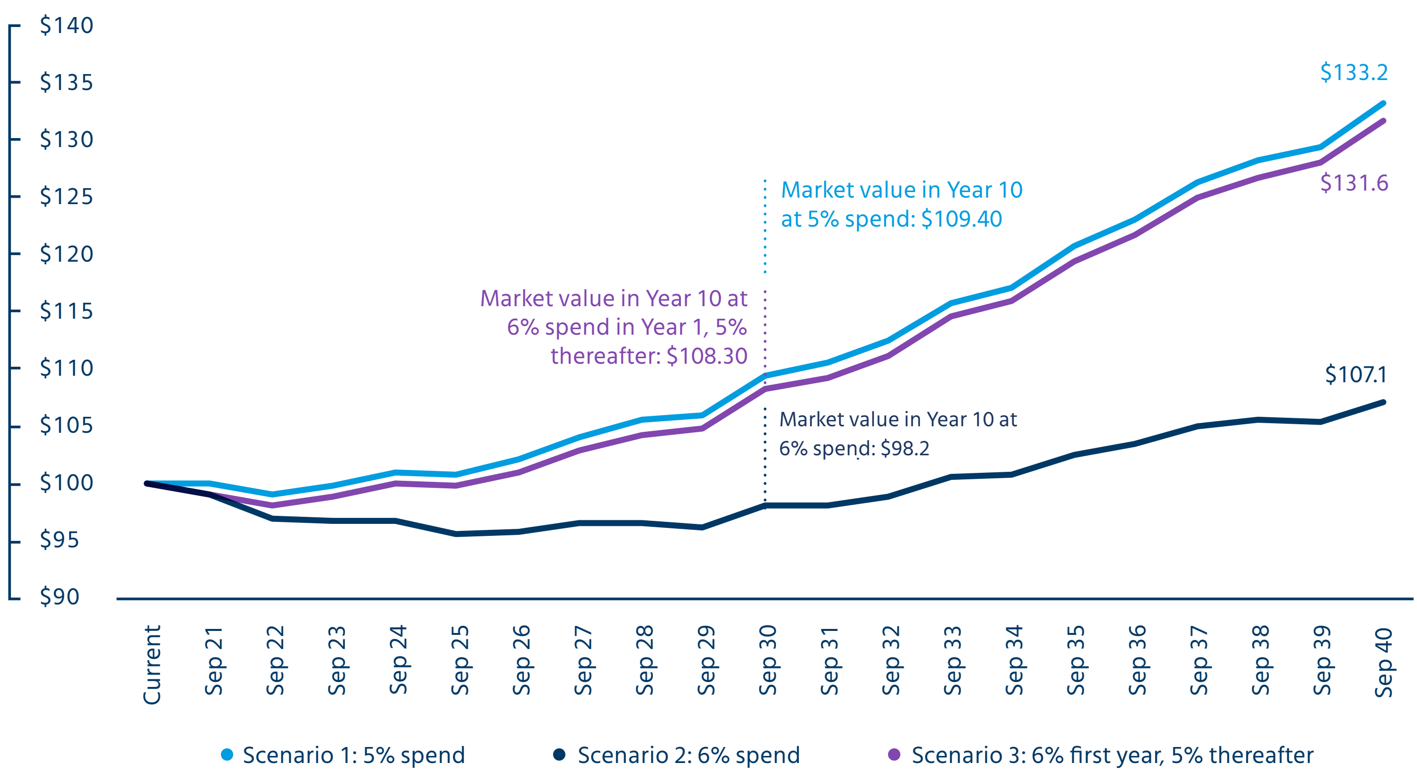
The swiftness and severity of the COVID-19 market drawdown and the rapid recovery left many mission-driven organizations needing to make one-time special portfolio distributions or accelerate/increase their regular spending.

These actions had important short-term benefits, but the key to preserving intergenerational equity is discipline around these short-term actions. Intergenerational equity is not meaningfully affected if additional spending has a limited duration.

Short-term considerations: Consider a one-time bump in spending rate to meet greater mission needs: A one-year increase from 5% to 6% that reverts to 5% in subsequent years only has a 1% impact on the 10-year portfolio value.

Long-term considerations: Take a hard look at whether the pandemic's effect on your institution will be temporary or permanent, then revisit endowment dependence, portfolio risk and asset allocation accordingly.

Figure 1: Hypothetical $100 million portfolio — Impact of changes to spend rate



Note: For illustrative purposes only. Return assumptions are based on applying Mercer's October 2020 capital market assumptions using Mercer's E&F Unconstrained Growth reference portfolio (55% equities, 22% fixed income, 23% alternatives); assumes 6.6% annual return (gross, reinvested). There are inherent limitations of the sample portfolio as it does not represent actual trading. Assumes that asset allocations would not have changed over time and in response to market conditions.

Institutionalize checks and balances

Pandemic market volatility tested many governance structures. The most effective organizations learned lessons that helped establish protocols for enhanced communication among all the fiduciaries involved in the investment process: investment teams, committees and boards. Discussing and deciding which of these protocols should continue can ensure that each constituent is better equipped to make decisions for the institution as a whole under normal and stressed conditions.

Short-term considerations: Re-examine and document the most effective communication and engagement processes through the crisis.

Long-term considerations: Memorialize lessons learned around communication and decision-making in written policies or operational procedures to mitigate emotion in inevitable future crises.

Investments

Getting to 7.2% in a 5.0% world

Perpetual endowment portfolios distributing 5% a year and facing 2.2% inflation need to earn 7.2%. But our expectation for the 10-year return of a 60/40 mix of global public equity and core US fixed income is 5.0% — a 2.2% shortfall.[1] Embracing higher risk — including illiquidity and complexity, the hallmarks of the endowment model — may be necessary for long-term success. Balance these risks with a lower-risk but higher-quality fixed income portfolio. Remaining nimble and being prepared to be opportunistic should help to boost long-term expected returns.

Short-term considerations: Consider allocating toward higher-risk portfolios. Many long-term investors may not be taking enough risk, letting emotion or long-held biases get in the way of disciplined risk-taking.

Long-term considerations: Asset allocation drives long-term returns, so investors should carefully consider future return expectations when assessing new asset classes or the sizing of current ones. Additionally, refocus attention on manager selection where it is most rewarded, and simplify investments in asset classes that offer lower potential "added value-to-effort" ratios.

Revisit the role of fixed income

Some investors have moved toward riskier, equity-like forms of fixed income in the search for yield, but these strategies are not interchangeable with investment-grade fixed income. Yet, the outlook for absolute returns from investment-grade fixed income over the next decade is bleak, given historic low yields today, meaning that the "best" use of any defensive fixed income allocation should be to generate positive returns in a negative equity market, rather than upside capture. This also means that investors should consider diversifying risk-reduction assets into other low-beta alternative investments such as defensive hedge funds.

Short-term considerations: Review performance of various fixed income sectors and managers in the first quarter of 2021, and seek to diversify sources of portfolio protection while mitigating opportunity cost.

Long-term considerations: Inflation may rear its ugly head again. If it does, yield-curve steepening and interest rates may present more interesting opportunities to take risks in fixed income. Be alert to these longer-term developments.

[1] Expected returns are hypothetical average returns of economic asset classes derived using Mercer's Capital Markets Assumptions. There can be no assurance that these returns can be achieved. Actual returns are likely to vary. Please see Important Notices for further information on return expectations.

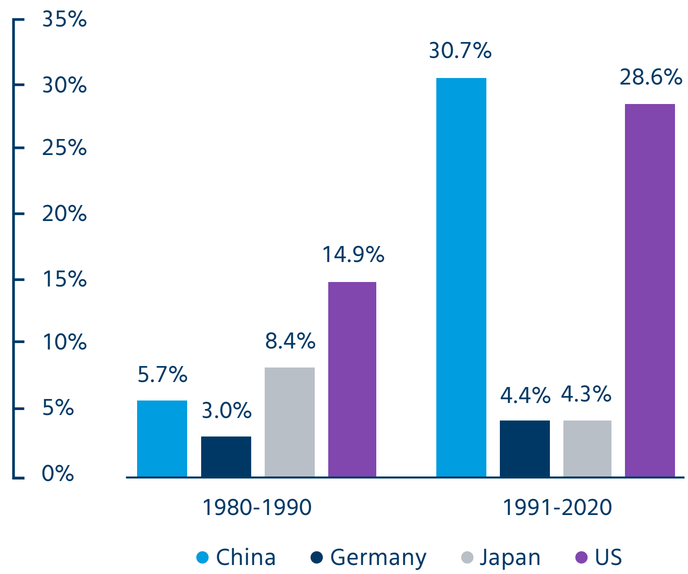
Differentiate global exposures

Investors were forced to contemplate the effects of the pre-crisis trade war between the US and China, and the pandemic-related halt to global trade. What would a less-synchronized global economy look like? We believe global mandates still serve as a portfolio cornerstone in an uncertain environment and that the growth of China merits its own consideration.

Short-term considerations: Analyze your portfolio's "look-through" geographic exposures and compare them to the most up-to-date global indices. Ensure that geographic tilts are entirely intentional.

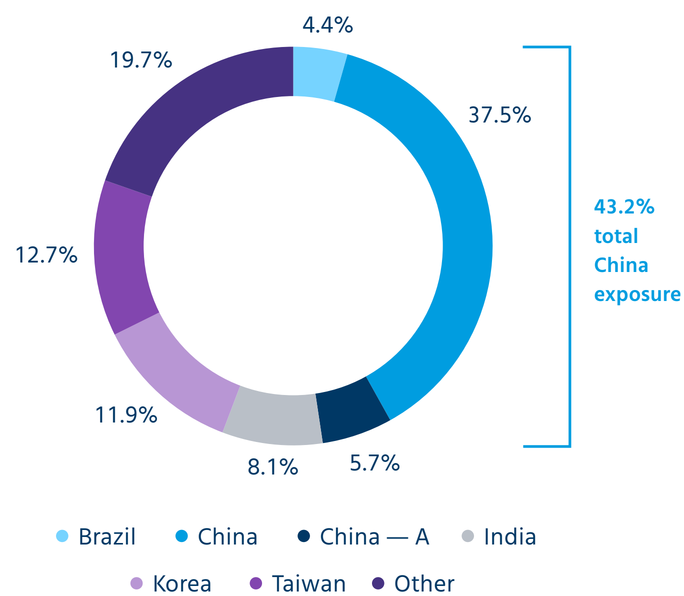
Long-term considerations: Build structural flexibility into the portfolio by allocating to broader mandates, letting the managers choose when to move assets to attractive opportunities. Consider China exposure through the framework of its future importance as part of the global stock market capitalization.

Figure 2: Contribution to global GDP



Source: MSCI

Figure 3: MSCI EM Index — 31 October 2020



Source: IMF

Contact us

Christopher Adkerson, CFA, CAIA
T: +1 314 982 5717
E: christopher.adkerson@mercer.com

Texas Hemmaplardh, CFA
T: +1 212 345 0713
E: texas.hemmaplardh@mercer.com

Russ LaMore, CFA, CAIA
T: +1 314 982 5680
E: russ.lamore@mercer.com

Ronak Patel
T: +1 312 256 6841
E: ronak.patel@mercer.com

Cori Trautvetter, CAIA
T: +1 636 686 5615
E: cori.trautvetter@mercer.com

Elizabeth Warren
T: +1 646 567 7260
E:elizabeth.warren@mercer.com

Important notices

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

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission.

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. While 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.

Investment management and advisory services for US clients are provided by Mercer Investments LLC (Mercer Investments). Mercer Investments LLC is registered to do business as "Mercer Investment Advisers LLC" in the following states: Arizona, California, Florida, Illinois, Kentucky, New Jersey, North Carolina, Oklahoma, Pennsylvania, Texas, and West Virginia; as "Mercer Investments LLC (Delaware)" in Georgia; as "Mercer Investments LLC of Delaware" in Louisiana; and "Mercer Investments LLC, a limited liability company of Delaware" in Oregon. Mercer Investments LLC is a federally registered investment advisor under the Investment Advisers Act of 1940, as amended. Registration as an investment advisor does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an advisor. Mercer Investments' Form ADV Part 2A & 2B can be obtained by written request directed to: Compliance Department, Mercer Investments, 99 High Street, Boston, MA 02110.

MARSH & McLENNAN COMPANIES

6011282a-WE