TIFF INSIGHTS

TIFF Roundtable Discussion

The Ongoing Search for Alpha in a Low Return World

Chicago – Summer 2018

After nine years of double-digit returns in most equity markets around the globe, can non-profit organizations achieve their investment goals in a low return environment? How might rising interest rates and inflation concerns be incorporated into portfolio positioning? Where are currently the most interesting investment opportunities? What are the most concerning risks in global capital markets today? Laura Kirkpatrick, Outreach Director at TIFF, moderated a panel exploring these and other topics during a regional roundtable at the University Club of Chicago on June 21st.

- William McLean (panelist): VP and CIO, Northwestern University
- Dick Flannery (panelist): CEO, TIFF
- Laura Kirkpatrick, CFA (moderator): Outreach Director, TIFF

Highlights from the Roundtable Discussion

Spending

While spending policy has been an important topic at many investment/finance committee meetings over the past year, our panelists agreed that a spending rate of about 5% per annum is still prevalent among most non-profit organizations. Assuming inflation of 2%, most non-profits seek an annual after-fees return of at least 7% annualized over a 3-5 year time frame. Looking forward, our panel believes that achieving this return objective will be quite challenging; many public equity markets are richly valued and fixed income yields remain historically low.

Portfolio Construction

Investment policy statements (IPS) that contain a disciplined framework for portfolio construction increase in importance in challenging market environments. Our panelists remarked that, while not identical, Northwestern and TIFF share a generally similar approach to asset allocation, relying heavily on equity-oriented strategies to drive returns while hedging equity market risk with diversifying, low-correlation strategies. Will and Dick agreed that performance of an endowment should be measured against a real return objective as well as a policy portfolio benchmark. Policy portfolio benchmarks provide guidance and objectivity, particularly in the medium-term. Despite the challenging market ahead, Northwestern has made no recent changes to its spending policy or its framework for asset allocation.

Asset allocation and portfolio risk

Trade policy, political tensions, threats of terrorism, North Korean aggression, etc. are all concerning and worthy of monitoring, but were not noted as key considerations for long-term portfolio positioning. Of greater concern are inflation and interest rates. Will believes that the benefits of US corporate tax cuts will likely taper next year, so his team at Northwestern is deliberating the impact of continued rate hikes by the Fed on economic growth, companies' earnings, and share prices. Similarly, while earnings reports continue to signal a healthy US economy, TIFF is cognizant of inflationary pressures and evolving Fed policy.

Our panelists described their asset allocation frameworks in more detail before highlighting areas of opportunity. While Northwestern's investment portfolio is designed to meet the return objective, funding rate and risk tolerances prescribed by the University's IPS, TIFF designs comprehensive portfolios and investment solutions according to its members' investment needs.

US vs. non-US equity? Relative to public market indices, Northwestern and TIFF portfolios are both overweight to non-US markets believing that current equity valuation levels are more attractive outside of the US. Further, both panelists generally favored emerging markets over developed ones and held relatively significant exposure to China.

Public vs. private? Those investors willing and able to accept the illiquidity associated with private investments (such as Northwestern) should benefit from exposure to privates. However, the panelists agreed that investors should be selective in their deployment of capital as not all segments (e.g., venture capital, buyouts, growth, special situations, secondary investments, etc.) and asset classes (equity, credit, real estate, natural resources, timber, etc.) currently reflect a beneficial risk/reward trade-off. Certain early stage venture capital, small/middle-market buyouts, co-investments, and credit strategies now display more attractive characteristics than opportunities presented in the secondary market, later stage venture and large buyouts. They recommended a steady, year-over-year allocation to private investments, culminating in a diversified portfolio structured to outpace public equity markets over the longer term.

Hedge funds? There is a role for hedge fund strategies in an endowment portfolio. Strategies with low- or no-correlation to public equity markets can provide protection in down markets. In addition, certain hedge fund strategies are designed to produce returns in excess of fixed income. Our panelists look to invest in strategies designed to meet or exceed CPI+5% net of fees, and they hold their managers accountable. Meaning, fees matter and should be commensurate with results. Hedge fund management fees have come down over the past several years, and better liquidity terms and more transparency into underlying holdings are available.

Passive vs active approaches? Our panelists believe that active-management remains appropriate for well-resourced, experienced investors with access to best-in-class managers and is especially important in a low-return, low-yield environment. A general recommendation: "favor passive in very efficient markets, and active in inefficient markets."

Fixed Income? TIFF and Northwestern's strategies diverged somewhat in fixed income with Northwestern owning some 30-year Treasuries as a deflationary hedge and TIFF primarily sticking with shorter-duration instruments.

Investment Opportunities

China and India were noted as areas of opportunity in both private and public markets, but investors must be highly selective with regard to company and approach. In hedge fund strategies, short-selling specialists could be well-positioned to capitalize on current market conditions. Co-investments were also noted as an area of interest but one in which caution should be exercised.

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Part of TIFF's mission is to promote within the non-profit community an understanding of investment management. Our events are offered with this goal in mind and in this spirit. Our Investment and Outreach teams are always available to speak with our members about TIFF's approach to capturing alpha. We are grateful to Will McLean for sharing his views at this Roundtable.

About TIFF

TIFF is a mission-driven, not-for-profit organization dedicated to delivering comprehensive investment solutions to foundations, endowments, and other charitable institutions. Since its inception in 1991, TIFF has exclusively served the non-profit community by providing experienced manager selection and access, risk-sensitive asset allocation, and integrated member service to institutions with long-term investment horizons.

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