Best practices in non-profit portfolio design

How non-profit investors can build a portfolio to help achieve their goals

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The market environment as we enter the 2020s is characterized by relatively high valuations on U.S. equities and low yields on fixed income. As a result, we believe it will be more challenging for non-profit investors to achieve their return targets than it would be in a typical market environment. Specifically, a portfolio that was previously designed to achieve CPI+5% may have achieved its objective over the last 10 years but may not be expected to produce the same return over the next 10 years.

A potential consequence of this is that investors are now faced with a decision as to the extent that they need to take on a higher level of risk or illiquidity in order to target the same level of return. The alternative would be to maintain a similar level of risk and to accept lower forward-looking returns or a lower likelihood of achieving their desired outcome.

We see investors with similar stated objectives make different decisions due to their specific risk constraints, preferences and/or views of the current market environment.

- Some investors with the long-term objective of CPI+5% may choose to maintain a less aggressive portfolio and accept a falling expectation of realizing their goals over the medium term because the downside and liquidity risks of the portfolio strategy required to achieve CPI+5% are not tolerable. This could be driven by organizational inability to tolerate a large reduction in spending from one year to another, the behavioral preferences of the investment committee and/or simply a belief that the risk/reward trade-off is no longer as attractive as before.
- Other investors may be able to tolerate the downside risk as they may be a grant-giving organization with few long-term obligations. Those types of investors could have higher allocations to liquid and illiquid return-seeking assets. This would increase the likelihood of achieving their goals and of maintaining their long-term impact while being able to navigate short-term losses.

Neither decision is right nor wrong. The important thing is that investors are aware of the trade-offs that are being made and are deliberate in constructing an appropriate portfolio strategy.

Model portfolio design

Historically, we have maintained specific model portfolios to demonstrate best practices in portfolio strategy for non-profit investors based on their return targets and liquidity constraints. The model portfolios guide the recommended asset allocation, but no two investors are alike, even if they have the same long-term goals.

Although we continue to define model portfolios, it is important to focus on the philosophy behind their construction to enable unique investors to take the framework and apply it to their situations. In addition, model portfolios are designed to reflect longer-term strategic beliefs with the understanding that their implementation will evolve with the market environment and the challenges that investors face.

For total return-oriented investors, the three main portfolio buckets are growth, return enhancement and risk-reducing/diversifying. How investors allocate across those buckets will drive their total return expectations, while allocation choices within those buckets will help drive portfolio efficiency. Russell Investments' non-profit asset allocation framework is aimed at guiding investors on how to allocate within those buckets, while the investors' circumstances and objectives will be the determining factor in how specifically they allocate across the buckets.

Growth

The core growth engine of the portfolio will be globally diversified public equities. Further diversification into real assets and return-seeking fixed income within the growth portfolio will reduce downside risk while maintaining high return expectations. While real assets and return-seeking fixed income have exposure to the same market drivers that impact equity returns, each sub-asset class has slightly different return characteristics such that volatility will be dampened, and drawdowns reduced when integrated into a more diversified growth portfolio.

Once the decision has been made to diversify the growth portfolio across equity, real assets and return-seeking fixed income, investors must determine the extent to which liquidity risk can be tolerated.

Return enhancement

Illiquid private market investments are primarily included to provide return enhancement above public market investments. The excess returns are generated from the illiquidity premium, the structure and leverage within the underlying investments, and the focus on value creation strategies within and across market segments that are less efficient and difficult to access within public markets. Of course, skilled implementation is also a critical element in delivering on the promise of private markets.

Within a well-diversified private markets portfolio, these strategies do not typically increase total portfolio volatility, because the ability to focus on different markets and strategies than are available in the public markets provides total portfolio diversification. In addition, experienced volatility is dampened by the smoothing associated with lagged appraisal-based valuations.

The return enhancement and total portfolio diversification does come at the cost of liquidity risk. The ability of an organization to take on such illiquidity will depend on its expected cashflow needs and potential shocks in cashflows during periods of market distress. If properly managed, many organizations can successfully operate with a large portion of their return-seeking assets in private markets. One organization might plan to consistently spend 5% of its assets, even if it means reduced spending in poor market environments, and that type of organization could tolerate a high level of illiquidity. Another organization might be planning for the possibility of a large outflow to fund a project and wouldn't have the same tolerance for illiquidity in its portfolio. The size of the allocation to return-enhancing private market investments relative to the liquid growth portfolio will depend on individual investor circumstances.

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Risk reducing/diversifying

The objective of many non-profit investors is focused on long-term portfolio growth. However, managing risk is often as important as generating returns. Risk management involves investing in asset classes that reduce total portfolio risk through diversification and dampening the exposure to a market cycle with lower expected drawdowns in a risk-off market. Some asset classes, such as treasuries, have typically delivered positive returns in risk-off market shocks.

Hedge funds and core private real estate are diversifying asset classes that are expected to reduce total portfolio risk, albeit with lower returns than growth and return enhancing investments.

- Hedge funds are a broad category of alternative investments, with some strategies having a growth orientation and others a low risk profile, but we assume investors construct a diversified hedge fund portfolio with an expected return and volatility between that of equity and core bonds. As the expected returns are generated by the skill and knowledge of the manager and investment opportunities beyond traditional markets, there is the expectation for a lower correlation with broad market returns than traditional long-only investments. Due to the reliance on manager skill to generate returns, investors must be confident in their ability to pick superior managers to allocate to hedge funds.

- Core private real estate has historically offered investors strong risk-adjusted returns and the potential for steady income with low correlations to broad equity markets.

Similar to hedge funds, core private real estate is expected to provide returns between those of traditional equities and core fixed income over a market cycle.

The diversification from hedge funds and core private real estate is expected to lower total portfolio risk but is not expected to provide tail risk protection in a risk-off market. These asset classes are important building blocks for an efficient portfolio but should be supplemented with risk-reducing fixed income for more effective risk control.

The total portfolio risk reduction provided by fixed income investments is driven by the treasury duration exposure. In a risk-off market in which the return-seeking portfolio is experiencing drawdowns, treasuries typically provide positive returns to offset some of those losses.

Credit oriented fixed income exposures are expected to provide higher returns than treasuries through the market cycle, and still serve to reduce risk relative to equities; however, they are not expected to provide the same level of downside protection in a tail event. Absolute return fixed income strategies also provide diversification benefits through the market cycle but as they are designed to have low, or no, exposure to the direction of interest rates, they have limited ability to provide tail risk protection in a risk-off market when treasury rates typically fall.

For portfolios with high return targets and low total allocations to fixed income, core fixed income will be the most significant part of the fixed income portfolio. As the targeted return is reduced and the total allocation to fixed income grows, the recommended allocation to absolute return fixed income will also grow.

Total portfolio strategy

Exhibit 1 highlights recommended model portfolios for investors with differing return needs and potential liquidity constraints.

The differentiator across the high- and moderate-growth portfolios is the total allocation to growth and return enhancing strategies relative to the total allocation to risk-reducing fixed income strategies.

Further, an investor with liquidity constraints may have no allocation, or a lower allocation, to private capital – and will require a higher overall allocation to growth assets to achieve a similar return, resulting in greater volatility. Often investors tolerate a reduced expected return when faced with liquidity constraints in order to moderate the expected increase in portfolio volatility.

Conclusion

We would not expect all investors with the same return objectives to have the same asset allocations, as preferences for controlling drawdowns, portfolio liquidity, fees and reliance on skill-based strategies could lead to adjustments from the stated model portfolios.

Nevertheless, investors can identify an appropriate portfolio strategy for their objectives, taking into account their unique circumstances and preferences, by following the model portfolio framework outlined in this paper.

Exhibit 1: High- and moderate-growth model portfolios

	HIGH GROWTH	HIGH GROWTH WITH LIQUIDITY CONSTRAINTS	MODERATE GROWTH	MODERATE GROWTH WITH LIQUIDITY CONSTRAINTS
Public equities	30%	49%	17.5%	30%
Public real assets	6%	9.5%	3.5%	6%
Return-seeking fixed income	4%	6.5%	2%	4%
Private markets	20%	-	12%	-
Core private real estate	5%	5%	5%	5%
Hedge funds	10%	10%	10%	10%
Absolute return fixed income	6%	5%	12.5%	11%
Core fixed income	19%	15%	37.5%	34%
10 Year Expectations:				
Real return	5.2%	4.8%	4.0%	3.8%
Volatility	7.5%	10.1%	5.8%	7.4%

Source: Russell Investments, market conditional capital market assumptions as of 6/30/2019. Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. There is no guarantee that any stated results will occur.

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