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Top considerations for endowments and foundations in 2022

This paper investigates key threats and opportunities that we believe are set to shape the investment environment and suggests how to respond across multiple asset classes.

The global economic recovery, expansionary policy and supply chain bottlenecks mean inflation will likely remain elevated throughout 2022. This has implications for the roles of public and private debt and, combined with other factors, means investors may need to rethink diversification. The climate transition will also require a "total portfolio" response across all asset classes.

2022 might also create new opportunities, not least in the disruptive technologies that emerged during the pandemic. Technology may also be central to the future democratisation of finance. China's economic rise continues unabated so it may be a good time to reevaluate its portfolio weighting. Endowments and foundations will also be interested in the major trend of impact investing, which could create positive impact without sacrificing returns.

1. Emphasize inflation protection

Monetary and fiscal stimulus have continued, despite a recovering economy. Although the amount of monetary stimulus is expected to taper, monetary authorities seem to be shifting their attention to job creation from inflation control increasing the risk of structurally higher inflation. While most major central banks believe the current rise in inflation is transitory and that inflation will fall back to normal levels, historically inflation has been difficult to predict. In addition, increasing tribalism in politics places a question mark over future fiscal policy. Together, the range of potential inflation scenarios in the future has increased, and scenario analysis that takes the risk of higher inflation into account is vital, as it can provide investors with crucial insight into the impact of inflation on various portfolios.

Considerations

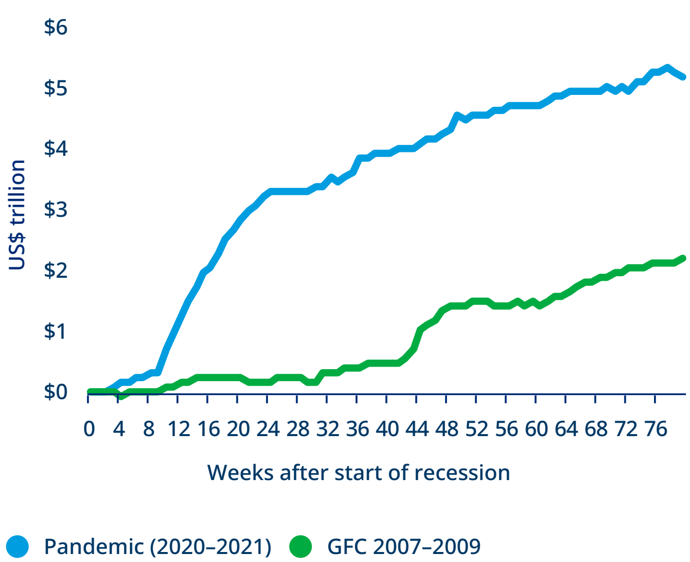
Explore how client portfolios — particularly those with significant weighting towards equities and bonds — might perform in an environment with persistently high and volatile inflation.

For traditional portfolios, heavy in assets that do well in stable, low-inflation environments, adding more inflation-sensitive assets can improve forward-looking portfolio robustness. Examples include real assets such as real estate, infrastructure and select equities.

Investigate the suitability of other hedging assets, such as commodity-oriented strategies and gold. These may prove valuable additions to portfolios, as they can help in scenarios where there is stagflation.

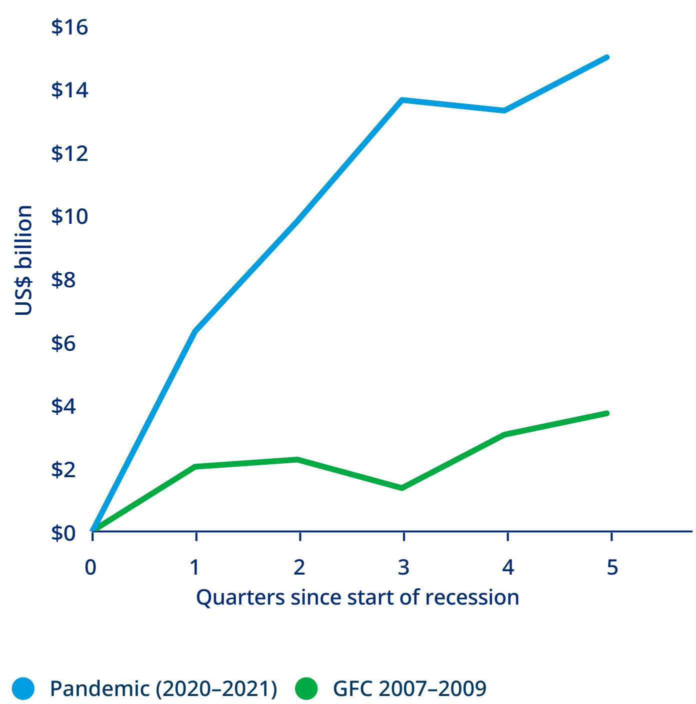
Analyze potential exposures to floating rate fixed-income assets. These may help in scenarios in which inflation is met with an aggressive rate response. They should also help protect against duration risk.

Figure 1. Cumulative change in US public debt outstanding since start of recession



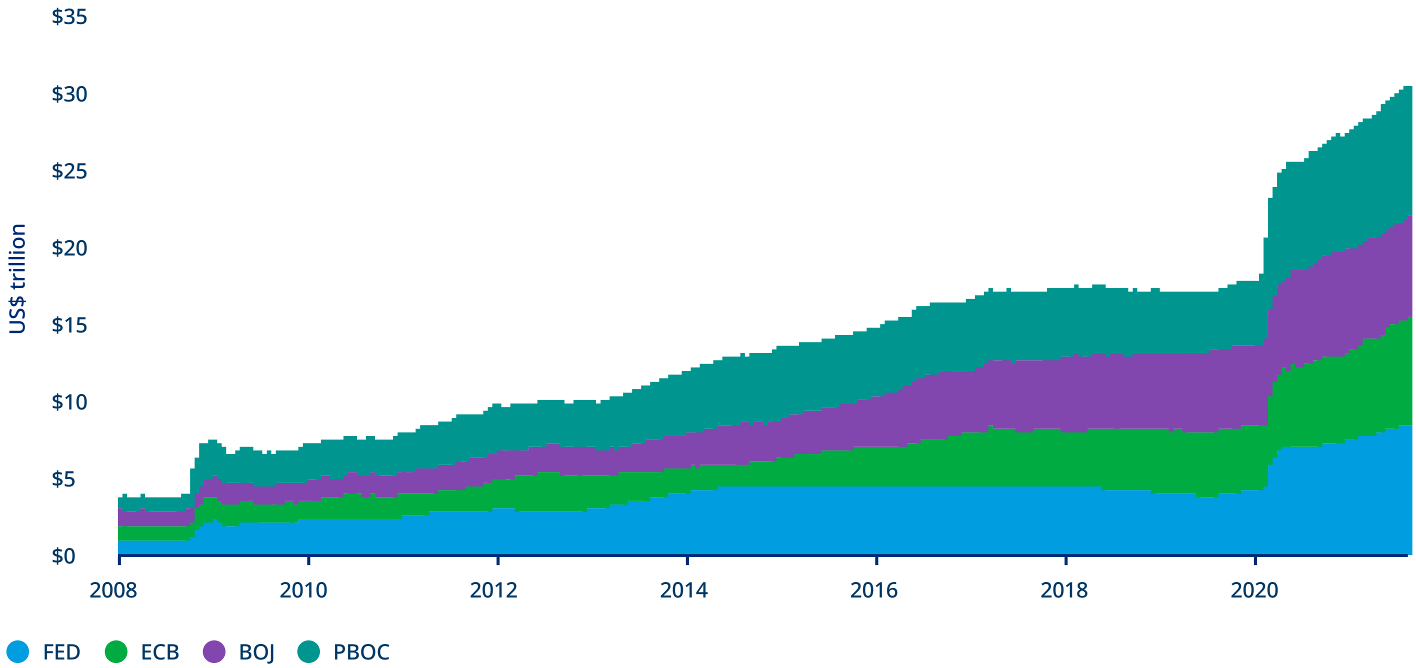
Source: Bloomberg. Data as of September 2021.

Figure 2. Change in US government debt since start of recession



Source: Institute of International Finance as of June 2021.

Figure 3. US Central bank balance sheets



Source: Bloomberg. Data as of September 2021.

2. Reassess China exposure

China has outgrown most major economies over the last couple of decades and is likely to do so for some time to come. China is significantly underrepresented in both standard benchmarks and many investors' equity portfolios. In addition, exposure to China in emerging market equity indices is, for historical reasons, heavily tilted toward its offshore equities. This overlooks the likelihood that the future dynamics of China's economy will be increasingly reflected in its onshore equity market, often referred to as China A-shares.

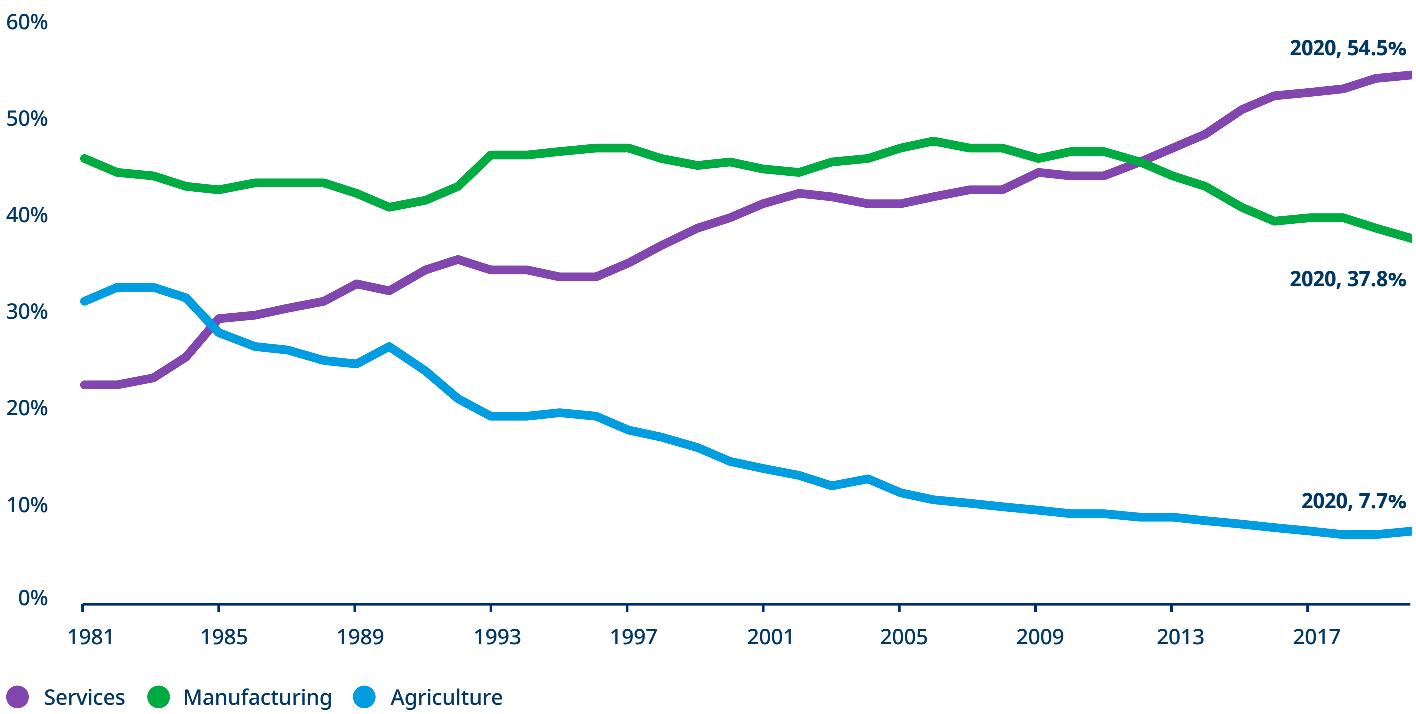
China A-shares offer the prospect of low correlations with other equity markets, an abundance of alpha opportunities, and exposure to higher economic growth rates, but they come with political and ESG risks.

Considerations

Consider holistic China onshore and offshore listed equity exposure given China's importance in the world economy and the alpha opportunities for active managers arising from the current uncertainties.

When allocating via A-shares, consider how ESG risks are integrated by your investment managers; for example, how to tackle social and environmental challenges in the region.

Figure 4. Shift in drivers of China's GDP



Source: Bloomberg. Data as of December 2020.

3. Invest with impact

Consider impact investing, with an explicit intention and objective to deliver positive, meaningful, and measurable social or environmental outcomes in underserved areas, alongside a financial return. We believe that an impact approach, when executed well, can generate returns competitive with broad markets. But there are instances where certain impact investors may wish to sacrifice returns willingly in order to generate a highly specific impact. Work still needs to be done on encouraging firms to embrace diversity and inclusion practices, which can foster staff retention and build robust internal decision-making, particularly in the financial industry.

Considerations

Private markets, particularly venture capital, are great ways to generate impact. Private market investors typically provide financing directly, instead of just shuffling ownership rights as occurs with trading listed equities. Purchasing listed equities does have some impact, lowering the cost of capital for companies, although private-market investments can have a greater impact by initiating new projects and allowing investors to influence companies' practices more directly.

Understanding the companies you have exposure to in your listed equities portfolios can help you understand how your portfolio could change to generate more positive impact.

4. Examine the impact of climate transition

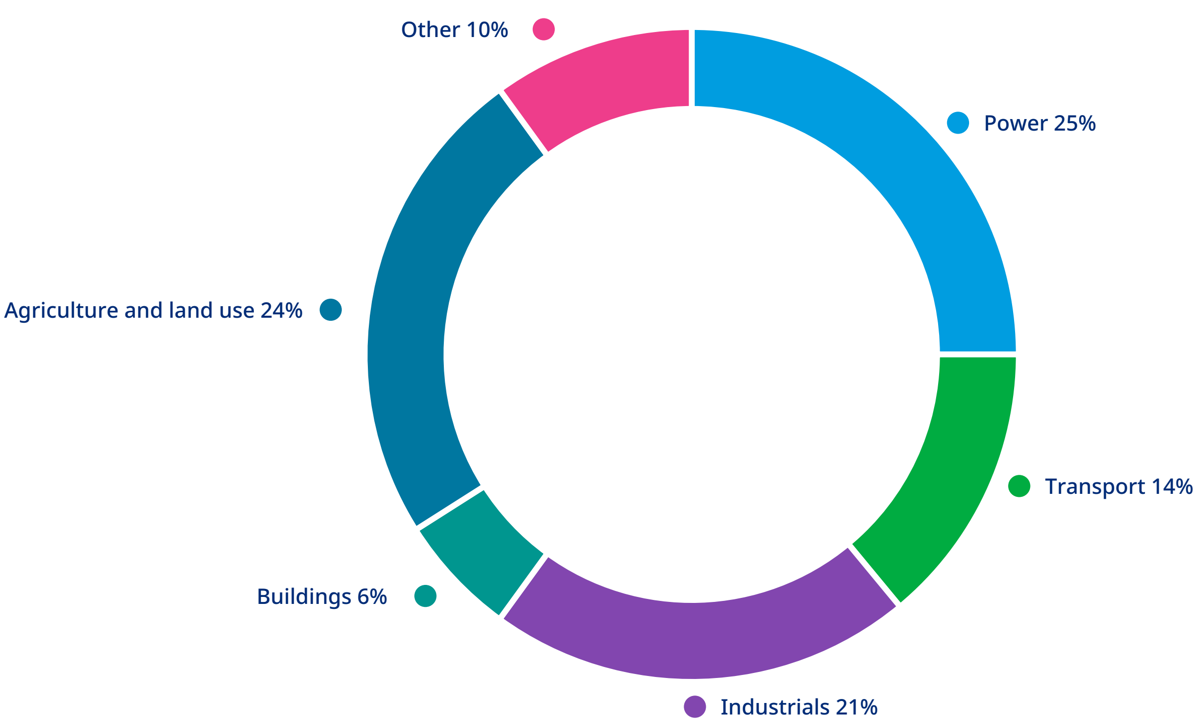
Climate change is a global, multi-industry problem, which we believe requires a "total portfolio" response. High emissions and high transition assets involve risks that are unlikely to reward investors over the long term. As the saying goes, there are no bad assets, only bad prices. With that in mind, we have to ask, is the price right?

Considerations

Assess your exposures to climate risk that are "grey," "green" and "in-between." What we call "grey" assets involve high emissions and high climate transition risk, while "green" assets involve low or no emissions and low climate transition risk. Of course, there is a lot of "in between." Exercise decarbonization at the right price (DARP). As with any major trend, climate transition will not happen in a straight line; nor will price recognition. Flexibility built into your strategic climate transition plan will be very helpful.

Consider investments in assets that are looking to make positive contribution to climate change issues, such as renewable energy and innovative technology companies within private markets.

Figure 5. Global emissions by sector



Source: Brookings Institute. Data as of December 2020.

5. Embrace disruption

The pandemic accelerated the rise of technology and tech-enabled services across multiple facets, allowing work, doctor visits and global commerce to continue when the rest of our lives were at a standstill. The necessity of surviving a global pandemic led to a lot of invention and technology adoption, creating opportunity from the ripples of these disruptions.

Considerations

Consider private market investments that are poised to capitalize on these growing opportunities.

Private debt and hedge funds can offer access to new loans coming from disruptors such as fintech or biotech.

6. Revisit the role of fixed income

Low absolute rates and low credit spreads have resulted in negative real yields for most of the bond universe. Interest rate risk offers little compensation and leaves portfolios exposed to inflation. However, high valuations in public credit markets have been slow to leak into the private credit market, which is also less exposed to potential financial market volatility, due to its higher exposure to floating rates and their lagged pricing.

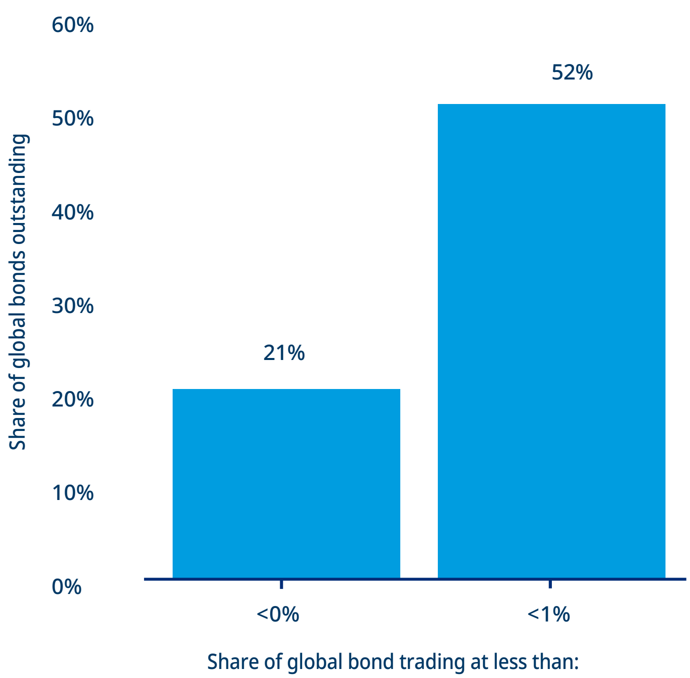
Considerations

Establish a clear understanding of the role of fixed-income assets in your portfolio. Are they included for risk-reduction or income-generation purposes?

Consider private debt and other lower-beta strategies to diversify rate and credit exposure in your portfolio and potentially provide higher total returns than those implied by very low traditional public fixed-income yields.

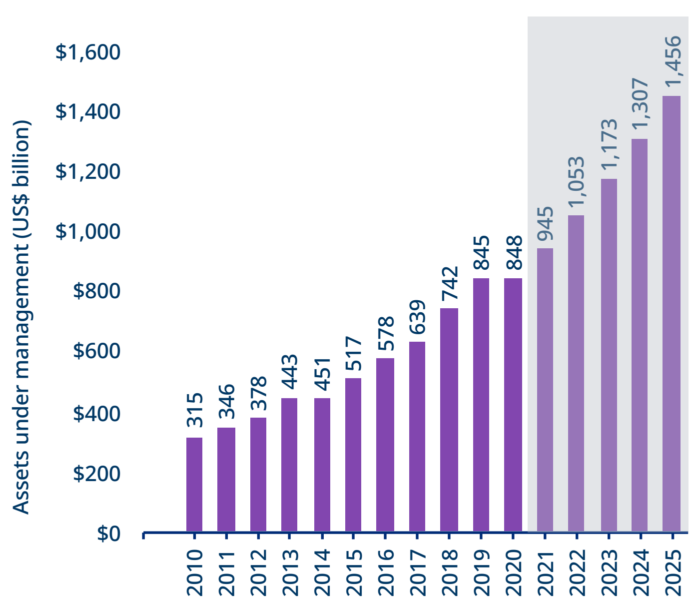
Consider the risk involved in moving allocations to higher-yielding but lower-quality investments. Is it worth the potential loss risk in your portfolio if credit markets deteriorate?

Figure 6. Over half of the world's bonds trade at less than 1% (absolute return)



Sources: Apollo, Mercer as of September 2021.

Figure 7. Private debt assets under management and forecast, 2010–2025*



Source: Preqin
* 2020 figure is annualized based on data to October 2020.
2021–2025 are Preqin's forecasted figures.

7. Rethink diversification

The "traditional" 60/40 balanced portfolio that depends heavily on beta exposures is unlikely to be able to produce the same results over the coming decade that such exposures produced in the past decade. Investors should carefully consider diversification and what it will mean in the future.

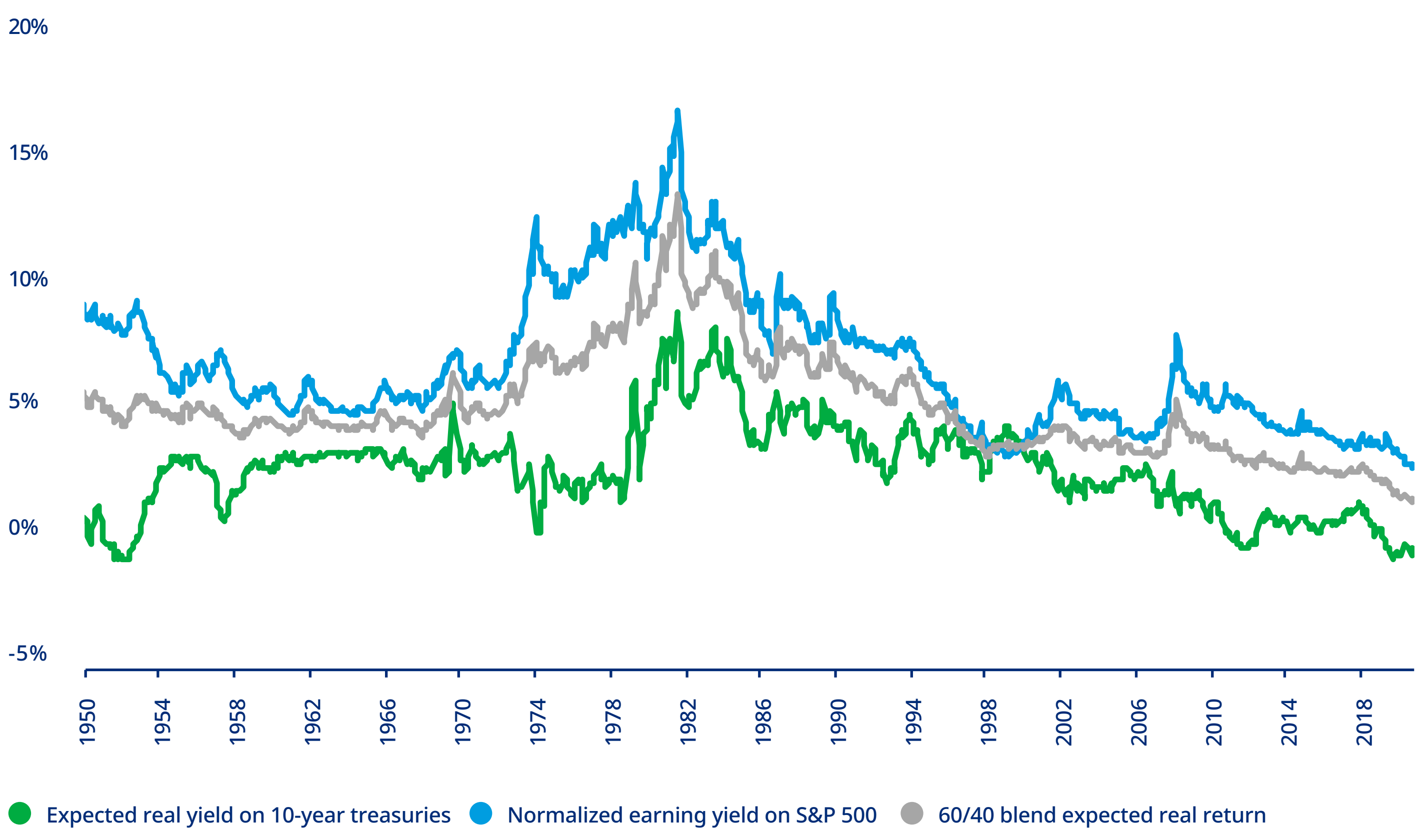
Considerations

Consider a diversified set of exposures to equities, focused on a few key long-term themes.

Explore alternative investment strategies, such as private equity and private debt. Over a market cycle, these are designed to provide portfolios with additional sources of risk-adjusted returns.

Downside protection is often expensive, so strategies that provide steady returns regardless of market direction could have merit. A mix of high-conviction downside protection strategies can be warranted, as any individual strategy can fail to protect in every type of downside event. Historically, many ways of doing this have blended well. Contractual approaches, such as options strategies, are subject to credit risk, often have counterintuitive pay-outs and come with a cost of carry. A mixed approach can be beneficial but is highly governance intensive.

Figure 7. Real expected returns on stocks and bonds



Sources: S&P, Bloomberg, Mercer, as of September 2021. 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.

8. Consider the future of finance

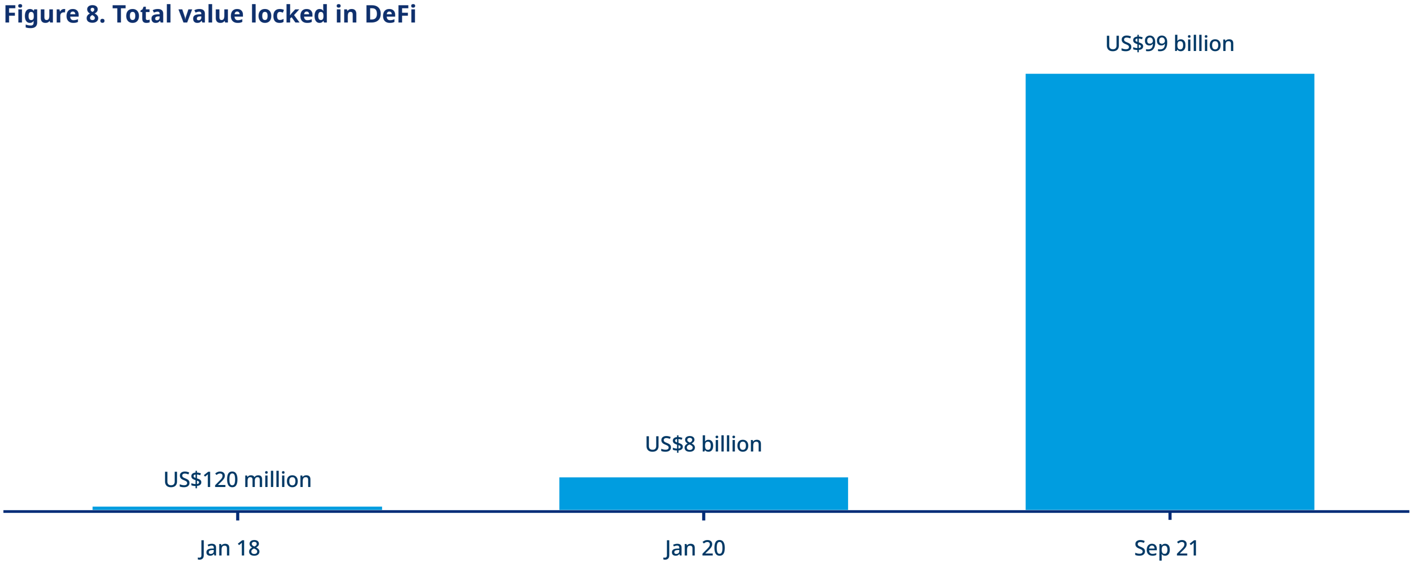
Private pools of assets are playing an ever-greater role in financing markets. We are seeing the technology-led democratization of finance, but as some financing activity moves underground, the risk of bubbles increases. Most notably, cryptocurrencies such as Bitcoin are becoming more mainstream, driving the growth of the decentralized finance system (DeFi) — a parallel financial services system native to the internet, run largely autonomously, providing services to holders of cryptocurrencies.

Considerations

Consider hedge fund and private debt opportunities focused on specialty finance and venture capital opportunities in new, often highly scalable platforms.

Explore options for accepting and selling cryptocurrencies, which may be received as gifts to your organization.

Figure 8. Total value locked in DeFi



Source: DeFi Pulse.

Endowments and foundations invest for the long term — generations. This paper has focused on the short term, looking ahead at 2022 for opportunities, with a view that the long term is made up of a lot of short terms. What really drives portfolios' long-term returns is having the right overall asset allocation and risk posture and the right governance structure for both short-term and long-term decision-making. Beyond this paper for 2022, we offer the links below to topics critical to endowments and foundations for the long term:

Staying on course: Position your portfolio post COVID

From acronym to action: What does ESG mean for Not-for-profit investors?

Contact us

We welcome feedback and dialogue about our observations on the future of investing for endowments and foundations in 2022. Please reach out to your Mercer consultant today.

Reshaping the future.

About Mercer

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Together, we're redefining the world of work, reshaping retirement and investment outcomes, and unlocking real health and wellbeing. We do this by meeting the needs of today and tomorrow. By understanding the data and applying it with a human touch. And by turning ideas into action to spark positive change.

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