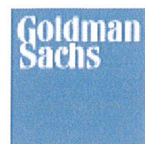


Investment Management Division

TOP FIVE

Investment Committee Discussion Topics

Goldman Sachs Institutional Client Solutions

Top Five Investment Committee Discussion Topics

INTRODUCTION

The recent Investment Strategy Group *2017 Outlook: Half Full* contained both good and bad news for nonprofit organizations. While the expected strength of the US economy, coupled with a low probability of recession, provides a healthy operating environment for nonprofits, lower expected market returns (see Exhibit 1) and heightened policy uncertainty pose challenges. Low expected returns, if realized, would diminish the ability of endowments to support ongoing activities. Tax policy changes could potentially have a negative impact on charitable giving.

Many investment committee discussions stem from these concerns. Below please find a "Top Five" list of investment committee discussion topics that are explored in this paper:

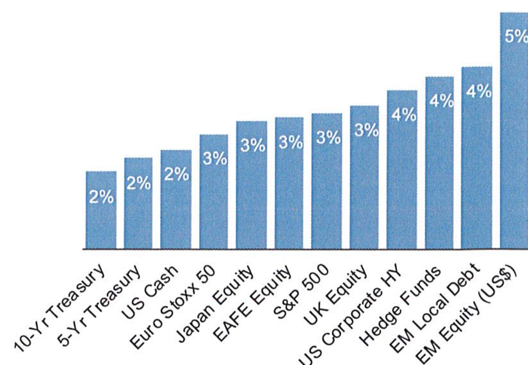
1. Modest Returns and Spending Sustainability
2. Active versus Passive Debate
3. Revisiting Hedge Funds
4. Tax Policy and Its Impact on Giving
5. Environmental, Social and Governance (ESG) and Impact Investing

1. MODEST RETURNS AND SPENDING SUSTAINABILITY

Despite intermittent periods of stress, the years following the global financial crisis have generally provided ample returns for investors. Unfortunately, these outsized returns came with a catch. As this period was characterized by rising equity valuations and falling bond yields, portfolios have likely seen returns "borrowed" from the future. A few years ago, the low-return debate revolved mostly around the investment grade bond portion of a portfolio and there was lively debate about the level of potential fixed income returns, the appropriate role of investment grade fixed income and its appropriate sizing in a portfolio.

Today, more and more investment committees are concluding that challenging returns are not isolated to investment grade fixed income. Rather, the entire portfolio faces significant headwinds. This conclusion is leading these same investment committees to ask difficult questions about their current spending levels and whether these levels are sustainable in the current environment without significant principal erosion.

Exhibit 1: Five-Year Annualized Prospective Total Return Projections (Rounded)



Note: These forecasts have been generated by the Investment Strategy Group (ISG) for informational purposes as of December 31, 2016. Return targets are based on ISG's framework, which incorporates historical valuation, fundamental and technical analysis. Dividend yield assumptions are based on each indexes trailing 12-month dividend yield. They are based on proprietary models and there can be no assurance that the forecasts will be achieved. Please see additional disclosures at the end of this publication. The following indexes were used for each asset class: BAML US T-Bills 0-3M Index (Cash); JPM Government Bond Index Emerging Markets Global Diversified (Emerging Market Local Debt); HFRI Fund of Funds Composite (Hedge Funds); MSCI EM US$ Index (Emerging Market Equity); Barclays US Corporate High Yield (US High Yield); Barclays US High Yield Loans (Bank Loans); MSCI UK Local Index (UK Equities); MSCI EAFE Local Index (EAFE Equity); S&P Banks Select Industry Index (US Banks); MSCI Japan Local Index (Japanese Equity), MSCI Spain Local (Spanish Equity). Source: Investment Strategy Group.

To frame these discussions, some investment committees have turned to financial modeling. Modeling makes these difficult discussions more productive as it allows the investment committee to evaluate how spending cuts today could impact the long-term health of the endowment. Without such a tool, decisions can be skewed. The pain of sacrifice today may be felt much more keenly than any future benefits of near-term spending reductions.

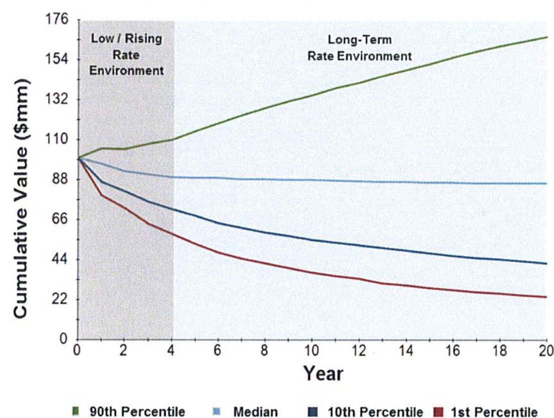
When using a data driven modeling approach, inputs to the model include the nonprofit's current strategic asset allocation and spending, return and inflation assumptions. The outputs could include the likely

value of the portfolio at 5, 10 and 20 years as well as a potential range of outcomes (see Exhibit 2) and the probability of maintaining the purchasing power of the portfolio at future points in time.

One of the trickier parts of the modeling is how to think about expected returns in the current low-return environment. Our modeling assumes that the Federal Reserve normalizes interest rates over the next few years. Alongside this interest rate tightening, expected returns of dampened asset classes should gradually rise. Once short-term rates reach their long-term equilibrium after the next few years, it is assumed that long-term asset class expected returns will revert to their long-run equilibrium levels.

A related question that investment committee members are discussing is whether or not their fiduciary duties obligate them to significantly reduce spending in anticipation of more modest returns? The rationale for reducing spending put forth by some investment committee members is intergenerational fairness (i.e., a dollar spent today is not available tomorrow) and the long-term horizon of an organization's mission. However, these long-term concerns must also be balanced against the immediate and intermediate impact of potential spending cuts on the organization's ability to fulfill its mission. The best decisions are made in a thoughtful and deliberate manner with careful documentation to memorialize their rationale.

Exhibit 2: Projected Growth of $100mm (Inflation-Adjusted) for a Moderate Risk Allocation with 5% Spending



Source: Investment Strategy Group.

2. ACTIVE VERSUS PASSIVE DEBATE

A common debate occurring privately in investment committee meetings and more openly in the press is active versus passive investing. An important driver behind this debate is the recognition that market returns are likely to be more modest going forward and that any dollar of fee savings is an extra dollar for the organization.

Quite often the debate is highly polarized with little subtlety. One is either an active investor or a passive investor ("you're either with us or against us"). Framing the debate in such an extreme fashion can be unproductive, as a portfolio can benefit from the inclusion of both active and passive strategies.

An analysis of investment managers' historical returns suggests that achieving excess performance has been easier in some asset classes than others. For instance, per an examination of the eVestment manager data, the historical median net excess return of US small cap equity and international equity managers exceeds that of US large cap equity managers. Intuitively, this finding makes sense as there are likely not as many information inefficiencies in US large cap stocks. This is due to the fact that there are fewer large domestic stocks and a greater number of investors who closely follow each company. With new information being quickly priced into stocks, achieving success as an active US large cap equity manager is more challenging.

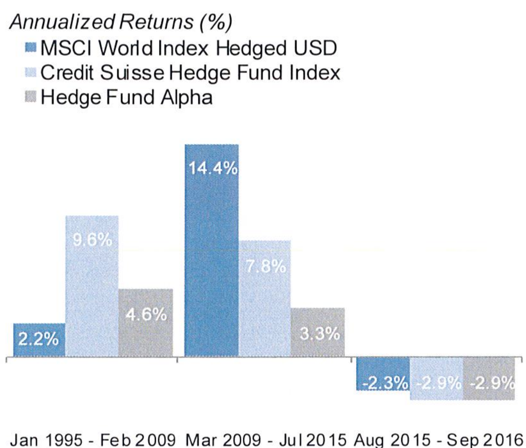
For investors with a greater sensitivity to fees, creating an active/passive barbell is an option to explore. To create an active/passive barbell, more efficient asset classes are implemented through lower fee passive vehicles. Less efficient asset classes are implemented through active managers. This would mean a greater emphasis on passive in the US large cap equity market and active in the US small cap and international equity markets.

An additional benefit that some investment committees have found with passive investing is that it can simplify their investments and, in turn, their meetings. As fiduciaries, investment committees need to understand and explain the performance of their active managers and why they are either outperforming or underperforming during a particular period. The use of passive investing eliminates the need for such performance discussions and allows the committee to focus on other potentially more important strategic issues.

3. REVISITING HEDGE FUNDS

A third discussion topic tied to the low expected return environment is whether investing in hedge funds is still appropriate. Recent disappointing performance has been a catalyst for this discussion and has caused many investment committees to shine a spotlight on issues such as hedge fund complexity, illiquidity, portfolio level diversification benefits and most prominently, fees. Given the more modest alpha produced by hedge funds following the 2008 financial crisis, there is a debate over whether a structural decline in alpha potential has occurred (see Exhibit 3).

Exhibit 3: Certain Environments Are More Conducive to Active Strategies



Source: "AIMS Perspectives: Hedge Funds 2.0". PerTrac Indices Database, www.hedgeindex.com. As of September 30, 2016. The indices referenced herein have been selected because they are well known, easily recognized by investors, and reflect those indices that the Investment Manager believes, in part based on industry practice, provide a suitable benchmark against which to evaluate the investment or broader market described herein. The first date shown is January 1995 due to the analysis utilizing 12-month rolling data. Investors cannot invest directly in indices. Past performance does not guarantee future results, which may vary.

Many thoughtful boards have taken a step back and revisited the basic rationale for including hedge funds in a portfolio. While boards can reach various conclusions on this question, we believe that despite recent lackluster returns, there is still a rationale for investing in hedge funds (especially for tax-exempt entities). The main reason for the inclusion of hedge funds is diversification which might be counter-intuitive to some investors who look to hedge funds for equity-like returns. Generally, an investor should expect a return somewhere between bonds and equities for a diversified portfolio of hedge funds (over the next 5 years, we expect about a 4% net return).

Managing expectations with respect to returns and the role played by hedge funds is important. While some board members might compare hedge fund returns to the S&P 500 index, this is not helpful as it not an appropriate comparison (hedge funds and equities play very different roles and have very different risk and return profiles). Such comparisons also often incorporate an underlying hindsight bias based upon more recent market returns.

Widespread unhappiness with fees, coupled with recent lackluster performance, has resulted in changes across the industry. Larger hedge fund investors have been demanding fee breaks and have been receiving them. As a result, the old standard fee structure of a 2% management fee and 20% incentive fee is becoming less common. Additionally, sometimes the pressure on hedge funds has resulted in access to previously closed managers. Finally, larger investors in hedge funds are unbundling the hedge funds themselves. Rather than simply investing in a diversified fund, some larger investors are identifying the best talent within a fund and asking for a specific carve-out of that talent (frequently with additional leverage or more attractive fee structures). For example, within a diversified equity long/short fund, the strongest strategy could be the fund's stock selection ability within the European financial sector. If a large investor held this view, they could create a sleeve that isolates the trading and talent associated with this sub-strategy.

So while hedge funds have struggled recently, there is a rationale for their continued but modestly sized inclusion in a diversified portfolio. However, investors must be comfortable with the illiquidity and added complexity, and have reasonable return expectations.

4. TAX POLICY AND ITS IMPACT ON GIVING

A major priority of the unified Republican government is tax reform. While no specific proposals have yet to be made that would directly impact nonprofits, uncertainty about potential changes to the deductibility of charitable contributions by individuals has the potential to indirectly impact nonprofits. This uncertainty led many individuals to greatly accelerate charitable giving into 2016 based on the

concern that tax benefits associated with giving might be diminished in the future. Many private foundations, donor advised funds and public charities were the beneficiaries of this late 2016 trend.

There are several potential changes to the tax law that worry generous donors because the tax benefits of charitable giving might be diminished in the future. This too is a concern to some investment committees as a decline in the amount received from fundraising could result in a greater burden on nonprofit reserves and endowment funds. The specific changes that might come into play follows, based on prior proposals put forth by President Trump or House Republicans:

- **Lowering of the Top Tax Bracket:** A lowering of the top bracket from its current 39.6% to the proposed 33% reduces the tax benefit provided by the charitable deduction. While individuals would still benefit from a tax deduction associated with charitable giving, it would be worth less in a lower tax rate environment. This might cause some donors to scale back on gifts.

- **Itemized Deductions:** While a few proposals are being considered regarding deductions, an overall deduction limit would make giving less tax efficient. Donors with intentions to make large contributions could see their deductibility capped or diminished.

- **Increase of Standard Deduction:** Increasing the standard deduction (estimated to cause only 5% of taxpayers to itemize instead of the current 35%) could make giving less attractive to the middle class, as they would lose the incentive to dedicate dollars to charity.

- **Estate Tax:** Eliminating estate taxes on assets passing to non-charitable beneficiaries could significantly reduce donor financial incentives to make testamentary charitable contributions.

If contributions of appreciated securities to private foundations are disallowed, taxpayers may have to consider alternatives or perhaps reduce bequests.

Most current commentary suggests that estate tax repeal and reductions to income tax rates would significantly reduce both lifetime and testamentary charitable bequests. Historically though, when significant tax reform (TRA of 1986, EGTRRA of 2001, JGTRRA of 2003) has taken place, average charitable contributions have actually increased or stayed relatively flat, even though the tax cost of doing so has also increased. However, the combination of the above income tax and transfer tax proposals could create an unprecedented perfect storm that could dramatically reduce incentives for taxpayers to make charitable contributions.

5. ESG AND IMPACT INVESTING

A final topic that is unrelated to the current market environment but is increasingly discussed by some boards is the adoption of Environmental, Social and Governance (ESG) and Impact Investing. While all nonprofits might take an interest in this type of investing, it has been most closely studied and embraced by nonprofits with a social or environmental mission, faith-based investors and family foundations.

Over the last few years, this field of investing has matured significantly. Investment opportunities have widened to include a breadth of institutional investment options across multiple asset classes. These types of investments can be broken down into three general categories:

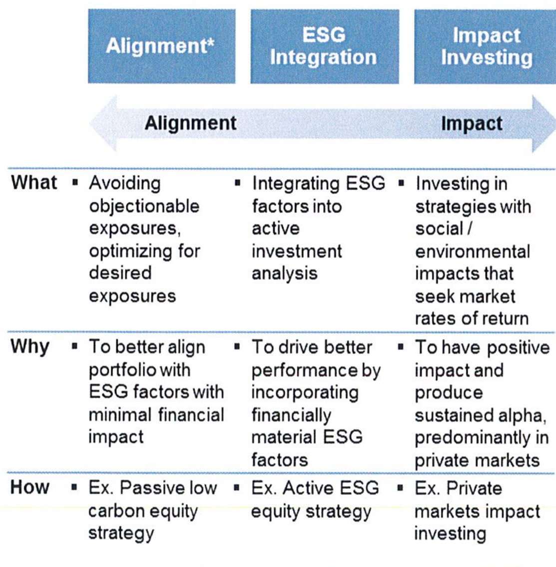
- **Alignment:** At the most basic, this investment approach – which is predominantly implemented in passive, public markets – excludes objectionable sectors from the portfolio (e.g., guns, alcohol, tobacco or carbon) and/or overweights other factors (e.g., carbon efficiency, companies with more women on boards, etc.). In its earliest incarnations, similar approaches relied on simple negative screens (historically referred to as Socially Responsible Investing). Over time, this approach has grown in sophistication as investors now seek to optimize alignment (either exclusions or tilts) in a more sophisticated, risk managed manner in order to reduce deviation from a conventional benchmark.

- **ESG Integration:** While Alignment is driven by rules-based screens or tilts, ESG Integration is a more nuanced approach in which ESG factors can add value through active managers. Rather than excluding stocks, this approach will proactively evaluate the ESG characteristics of an investment alongside traditional investment considerations. The rationale behind the approach is that evaluating the ESG factors of an investment might expose potential material risks or opportunities that have not been priced into the market. For example, a company that treats its workers well (a "Social" factor) may have more loyal and productive workers and could

outperform its peers over time. Conversely, a company that uses energy less efficiently relative to peers (an "Environmental" factor) might be at a competitive disadvantage due to higher input costs.

- **Impact Investing:** Impact Investing refers to private market investment strategies that seek measurable social and/or environmental impact alongside financial returns. As these are private investments, they will have much longer time horizons and are illiquid. Given the illiquidity, this approach would be appropriate for just a portion of a portfolio. Impact themes include renewable energy (e.g., solar and wind power), education (e.g., a company driving outcomes-based improvements for English Language Learners (ELL) in US schools), and healthcare (e.g., the development of healthcare infrastructure and services in emerging markets). Increasingly, there are opportunities to seek impact investments that target market rates of return alongside measurable and reportable social and environmental impacts.

Exhibit 4: Market Rate ESG and Impact Investing Spectrum



	Alignment*	ESG Integration	Impact Investing
What	▪ Avoiding objectionable exposures, optimizing for desired exposures	▪ Integrating ESG factors into active investment analysis	▪ Investing in strategies with social / environmental impacts that seek market rates of return
Why	▪ To better align portfolio with ESG factors with minimal financial impact	▪ To drive better performance by incorporating financially material ESG factors	▪ To have positive impact and produce sustained alpha, predominantly in private markets
How	▪ Ex. Passive low carbon equity strategy	▪ Ex. Active ESG equity strategy	▪ Ex. Private markets impact investing

Initially adopting an ESG and Impact Investing framework can take time as it requires defining the values of the organization and mapping these values to investment decisions. While some investors might seek to shift their entire portfolio towards an ESG and Impact Investing framework in a short period of time, investors more often view the transition as a gradual process that can occur over an extended period of time. This may result in incorporating a subset of the ESG and Impact Investing universe as an initial first step, depending on where it makes the most sense to begin given the portfolio context.

QUESTIONS

For any questions regarding the topics discussed in this publication, we welcome you to e-mail us at **icsimd@gs.com**.

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