HIGHTOWER
KLEIN WEALTH MANAGEMENT

HIGHTOWERADVISORS.COM/KLEIN
OFFICE: (888) 982-6705
FAX: (631) 794-2374

445 BROAD HOLLOW RD
SUITE 332
MELVILLE, NY 11747

THE ENDOWMENT SPENDING PICKLE

Endowments, similar to Foundations which are required to pay out 5% of their assets to charitable organizations annually to remain tax exempt, are geared to the goal of providing donations (or support) via the cash flow generated by their assets. Nonprofit organizations use these donations to sustain their mission and to develop long term initiatives—so clearly this cash flow is the life-blood of the nonprofit sector.

Taking it from the giver's perspective rather than the receiver's – How can endowments and foundations develop the sufficient cash flow from their portfolio to not disturb their corpus? How can they maintain these distributions given the current environment of ultra-low interest rates? In the years before the financial crisis—before the Federal Reserve's herculean efforts to stimulate the economy via ultra low interest rates and QE programs (buying bonds on the open market so to keep rates low) investor's had the opportunity to place capital on the "side-lines" at a relatively nice risk free rate of return (3-5%). However today that is no longer the case—as they say—cash is trash—in that it doesn't provide any substantive return.

So given the environment—financial repression as it has been referred to –endowments are in a pickle for they are finding it very difficult to make the return they need to in order to maintain their giving. The math is sobering:

- Given a 60% Equity and 40% Fixed income portfolio, whereby the fixed income sleeve is likely to achieve no more than 2% return (and that's no slam dunk for sure).
- To achieve a mid 7% return with a 60/40 portfolio would require the equity portion to achieve a near 12% return which is above the 25 year long term average.

So what is the investment committee of a foundation or endowment to do? How can the steward their portfolio—their greatest asset—to produce the returns they need to provide the charitable donations that many are counting on? Of course they can give less (although this is not an option for a foundation that is required to give 5%) but of course that doesn't help the nonprofits that rely on this giving. A couple of things that should be kept front and center in the minds of these investors:

- It doesn't have to be a yield – can be a total return. In other words one doesn't have to focus on just the dividend yield or cash flow from an investment – a fully diversified portfolio can provide a combination of capital appreciation and income to get closer to their stated return goal.
- Be careful of duration exposure– if rates go up you can be stuck in bonds with low yields—so don't "reach for yield"—measure the yield vs. the maturity—it's a tradeoff.
- Need to be mindful of these risks over the long and the short term—a case for Proactive/Tactical Investing. Here we are adopting a strategy of being more tactical with respect to asset allocation which is to say that we are being more mindful of the market conditions before investing. Being more nimble and opportunistic—this is not the buy-and-hold market environment of years ago—this "new normal" requires a new toolbox.
- Market neutral investing can also provide ballast to an overall portfolio that increases and decreases risk exposures as market provide opportunities –over the intermediate term not short term. With market neutral strategies the investor hedges his equity exposure through convertible arbitrage and long/short strategies. Sure you may not make as much versus an "all-in" strategy but that is not the goal here—the goal is to provide a foundation to an overall tactically allocated portfolio.

All of the above strategies notwithstanding the bottom line is still know what you own and have a plan to get to your goals. We recommend utilizing an Investment Policy Statement and portfolio aggregation software to solve for these objectives.

		TOTAL RETURN OBJECTIVE	REQUIRED EQUITY RETURN		FIXED INCOME TOTAL RETURN
Low fixed income returns have challenged traditional portfolio allocation models. **LONG-TERM S&P 500 RETURNS©:** 40 Year: 11.0% 25 Years: 9.5%		10.0%	**15.4%**		2%
To achieve a 7.7% overall portfolio return, a premium to historical equity returns must be achieved.	**ENDOWMENT RETURN TARGET®**	**7.7%**	**12.0%**		2%
		6.0%	**8.6%**		2%