

Endowments & Foundations: Taking a Holistic View to Weather the Storm

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The severe disruption that is taking place in the higher education industry is like nothing we have seen before. In a time like this, it is logical to try to compare the current environment to an event or period from the past. After all, doing so provides us with lessons to draw on as we work to analyze and make sense of the problems that will continue to impact the space.

Although there is temptation to compare recent events with that of the Great Financial Crisis (GFC) of 2008-2009, what is happening as the result of COVID-19 is perhaps even more severe in terms of its ultimate impact on colleges, universities and other non-profit institutions. In addition to the impact on endowment values, the entire operational structure of schools has been markedly disrupted. Furthermore, the uncertainty with respect to forthcoming semesters (e.g., enrollment data) is creating difficulty when trying to determine what operating budgets will look like for FY 2021. All of this in turn materially impacts how one thinks about both sides of the balance sheet because of the need to create liquidity to fund a range of potential operational outcomes.

Governance

Recent volatility in the marketplace has institutional investors and their governing bodies concerned about the drawdown of endowments and their spending policies' subsequent ability to meet budgets to support their institutions. COVID-19 has created a greater sense of awareness with regard to the interdependency of revenue and spending at non-profit institutions. Of interest to our clients in this discussion are budget tightening and board planning, taking into consideration the increasing importance of the investment portfolio as it relates to the operating needs of the non-profit organization. As a result, a growing number of boards are taking a holistic view, looking beyond investment returns and asset allocation; focusing on the balance sheet, tuition dependency, fundraising, other sources of revenue and good governance.

Boards are also outsourcing in the areas of planned giving, investment management, and administration, thus creating greater accountability for meeting performance benchmarks and achieving pre-set milestones. Now is also a prudent time for boards to evaluate the effectiveness of policies and internal procedures, including:

- Audit
- Conflict of Interest
- Fundraising
- Investment
- Personnel
- Risk Management
- Spending

Asset allocation and spending are integrally linked, yet many institutions do not consider their spending rate. In most cases, an operating budget has significant sensitivity to performance derived from asset allocation. The task of determining which spending policy to use and a spending rate that balances out the needs of a non-profit organization is critical. A board should strive to understand the institution's risk profile, e.g., its ability to maintain and grow the endowment and its ability to provide liquidity and operating support.



Stress testing the spending policy can be a worthwhile exercise. A holistic view of assets and liabilities can inform a board with insights about revenues and expenses, balance sheet strength, risk appetite, and help to achieve better risk-adjusted returns and sustainability.

Endowment Spending Policy

It bears highlighting the importance of the investment committee reviewing endowment spending policy. A well-developed spending policy is critical to mission sustainability and the preservation of intergenerational equity. Good upfront planning and development of spending and investment policies may also help protect assets, especially during a crisis. Spending policy challenges institutions may face: lower returns, spending from underwater endowments, greater reliance on the endowment, and sharp fluctuations in spending budgets and asset values.

While there are a myriad of spending formulas utilized, some important spending policy ideas to consider, especially when planning for a market crisis, include:

- Establishing a sustainable “hurdle rate” that includes the spending rate plus inflation (CPI or HEPI), administrative fees, or any desired growth is critical. Endowments have failed to consistently hit return targets over 7%, having seen an average return of just 5.9% over the last 21 fiscal years.¹
- Most institutions use a 3-year (or rolling 12-quarter) smoothing period when calculating endowment spending. However, using a longer smoothing period may help reduce spending volatility and preserve endowment corpus over time.
- Establishing an “Endowment Immunization” or “Spending Reserve” Fund (when times are good), consisting of 12 to 18 months of liquidity needs invested in relatively safe assets, helps provide a cushion and peace of mind during a recession.
- Consider a special allocation from the endowment in Q3/Q4 of 2020 to help offset increased demand from operations.

Asset Allocation

Even under ideal conditions, it can be challenging to generate expected investment returns. However, in the current environment, that task might be downright daunting. In short, making “panic” decisions, or decisions that are not well thought out or vetted can lead to a marked decline in the value of a portfolio. This is not the first bear market, nor last, and throughout history, for every decline there has been an eventual recovery. Our view is that there are characteristics that lead to solid performance that have stood the test of time, and those should be employed. They are: discipline, proper diversification, and the willingness and ability to have a long-term investment horizon.

During periods of volatility, participating in, or even missing out on just a few trading days can dramatically impact performance. Using the S&P 500 as a simple proxy, in the past roughly 40 years (1980-2019), a “buy and hold” portfolio returned 11.8% annually. If that same hypothetical investor missed the 10 worst/down trading days in each decade, the return would have been 18.4%. On the flipside, if an investor missed the 10 best days in each decade, their annual return would have been 6.5%.²

Practically speaking, a given portfolio should adhere to a well-defined Investment Policy Statement, which recognizes long-term objectives, and is properly diversified across multiple asset classes, geographies, and sectors, and is also well balanced with public and private investments.

¹ Source: PFM analysis and NACUBO; trailing return shown for the fiscal years from July 1, 1998 to June 30, 2019.

² Bloomberg Data.



Banking and Liquidity Management

In order to help promote additional liquidity during the COVID-19 pandemic, the Federal Reserve (Fed) exercised a rarely used monetary policy tool, as it lowered the reserve requirement from 10% to 0% effective March 26, 2020.³

This change reduced banks' needs for deposits. This, in conjunction with the Fed's lowering of the overnight target rate range (to 0% to 0.25%), is expected to have a significant impact on the earnings credit rate (ECR) and the interest rate paid on bank balances. As higher education institutions face budgetary uncertainty and expenses, the tendency would be to increase "liquid" cash. Unfortunately however, these bank balances may now generate little to no economic benefit.

Therefore, in this rapidly changing environment, it is critical for higher education entities to conduct a timely review of their banking relationships, including the rate paid on balances, and compare it to other safe and liquid investment options in order to optimize their short-term earnings.

Debt Management

The most immediate focus for the use of debt during the pandemic revolves around the need for working capital. In March 2020, as colleges and universities were instituting policies and procedures regarding student refunds (for room and board fees) and there was uncertainty surrounding operating budgets, the focus was on shoring up liquidity. Many schools drew on their working capital liquidity lines, while others worked aggressively to put liquidity in place.

The cost of lines of credit increased quickly, and the tenor lines became shorter (lines commonly have tenors of one year or less). During the next several months, PFM feels it is prudent to formulate longer-term strategies to effectively manage working capital liquidity needs. This may take the form of using lines of credit for a period of time or may require the use of longer-term debt in some instances. Each situation must be customized, and the further ahead an endowment/foundation plans for a multitude of outcomes, the better.

Also, because there will be an increased focus on operational and endowment liquidity, debt portfolios should be reviewed for opportunities to improve liquidity risk on existing long-term debt. This is something that happened during the GFC, as colleges and universities moved to more stable liabilities on the balance sheet. Since then, most institutions of higher learning have erred on the side of caution; maintaining more conservative debt structures. Given the focus on liquidity, there may also be opportunities for colleges to de-risk existing exposure to liquidity risk by fixing out (going from a variable to a fixed rate) pieces of variable rate debt.

For those institutions with financial covenants on existing debt, there will likely be an increase in covenant violations. Each of those circumstances should be approached on a customized basis. However, the most important thing is to get in front of issues sooner rather than later. Institutions would then be able to "stress test" 2020 and 2021 covenants and identify where concerns might be.

Finally, it should also be remembered that during times of financial stress, credit spreads widen. Currently, capital markets are "open" for AA and better credits, but it is less clear where the market is on a day-to-day basis. Meanwhile, the market for "A" rated or lower credits is harder to predict. Although many financings for new capital have been delayed, there will still be financing needs for new capital, refinancing of existing debt, working capital or other reasons. Because the markets are changing quickly, PFM recommends institutions evaluate a variety of alternatives, and to keep all options open.

³ <https://www.forbes.com/sites/bobhaber/2020/03/16/the-fed-fires-the-big-one/#293282d66aa8>.



Final Thoughts

While other firms may work in limited silos, PFM works across an entire balance sheet, employing a true enterprise view to address the challenges that higher education institutions face. For a deeper discussion on any of the topics mentioned, please contact the Higher Education team at bassj@pfm.com and the Endowments & Foundations team at efpractice@pfm.com.

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