Latest Endowment Study Shows Enormous Returns in FY2021

Yet Long-Term Results Remain Challenged

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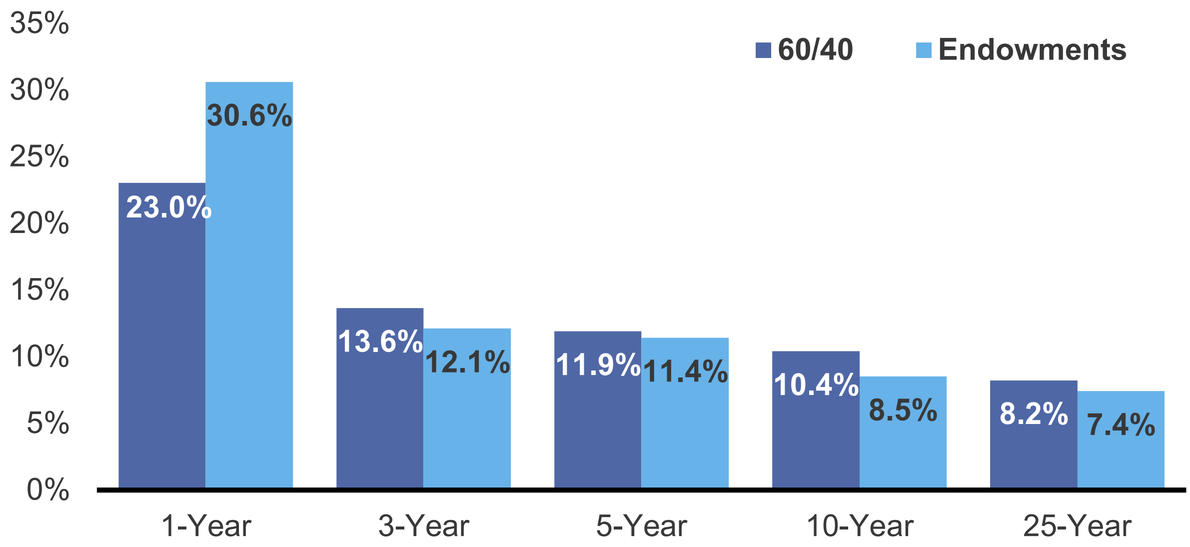
pfm asset management

Endowments Return Averages 30.6% for Fiscal Year 2021, But Still Lags a Traditional 60/40 Index Long-term[1]

According to the 2021 NACUBO-TIAA Study of Endowments (NTSE) published earlier this year, U.S. higher education endowments returned 30.6% on average for the fiscal year (FY) ended June 30, 2021. This represents one of the highest annual returns in 35 years, aided by a robust economic recovery following the COVID-19-induced recession. As a result, the 10-year annualized rate of return increased from 7.5% in FY2020 to 8.5% in FY2021. However, despite the high annual return, longer-term 25-year annualized returns decreased from 7.7% in FY2020 to a 7.4% yearly return in FY2021.

PFMAM also compared NTSE's trailing 10-year annualized return of 8.5% to the 10.4% annual return of a balanced 60/40 portfolio (60% S&P 500, 40% Barclays Aggregate). The underperformance of endowments relative to this plain index can be attributed to several factors, including higher fees associated with some active and alternative investments, as well as manager selection especially in alternatives where data shows that access to top-quartile managers can make a meaningful difference in long-term outcomes relative to selecting a median manager.

Average Annual Returns for U.S. Higher Education Endowments Compared to a 60/40 Index[1] as of June 30, 2021



2021 NTSE.

1 Endowments as represented by the 2021 NTSE. Returns are net of fees. Traditional 60/40 Index represented by 60% S&P 500 Index and 40% Barclays Aggregate.

Effective Spending Unchanged

The 720 surveyed institutions reported an average endowment spending rate of 4.5% in FY2021, barely changing when compared to the prior four fiscal years, as shown on the following page.

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Average (All Institutions)	4.6%	4.2%	4.4%	4.4%	4.2%	4.3%	4.4%	4.4%	4.5%	4.6%	4.5%

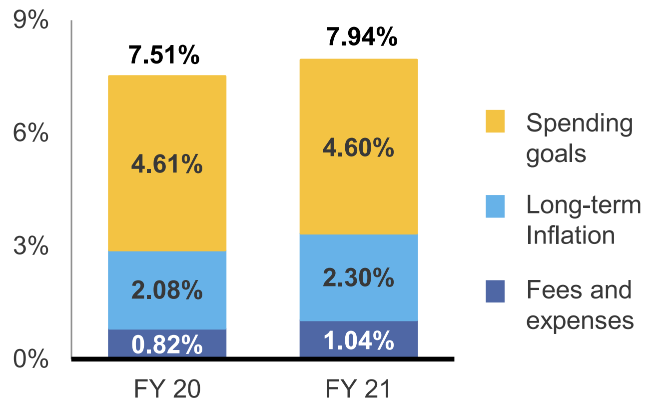
2021 NTSE. All data is reflected as of June 30 each year-end. The effective spending rate represents the distribution of spending divided by the beginning market value (endowment value on or around the beginning of the fiscal year). The distribution for spending is the dollar amount withdrawn from the endowments to support expenditures on student financial aid, faculty research, maintenance of facilities and other campus operations, as determined and defined by each institution. The rate is calculated net of any investment fees and expenses for managing the endowment.

Due to the COVID-19 pandemic and lower tuition revenues, endowments played a larger role in funding the operating budget of their institutions, where 57% of endowments saw increased support by endowments spending on their operational budget from FY2020 to FY2021. Student financial aid continued to be the largest beneficiary of this support, receiving 47% of all endowment distributions, while 20% of endowments made special appropriations in FY2021 beyond their normal spending policies.

Return Targets Rise Amid Inflation and Fees

For many years, a 7.5% long-term annual return target has been a common hurdle rate for endowments. But more institutions feel the pinch of growing expenses related to actively managed funds, alternative investments and other administrative fees. Additionally, a speedy recovery of the global economy has brought about higher inflation levels. With these new expectations, the long-term target rate of return for institutions has increased from 7.51% in FY2020 to 7.94% as of FY2021.

While the required rate of return has risen, investors expect lower returns from traditional fixed income due to rising interest rates. To help offset this, we believe endowments may need to review their strategic and tactical asset allocations to help close the gap.

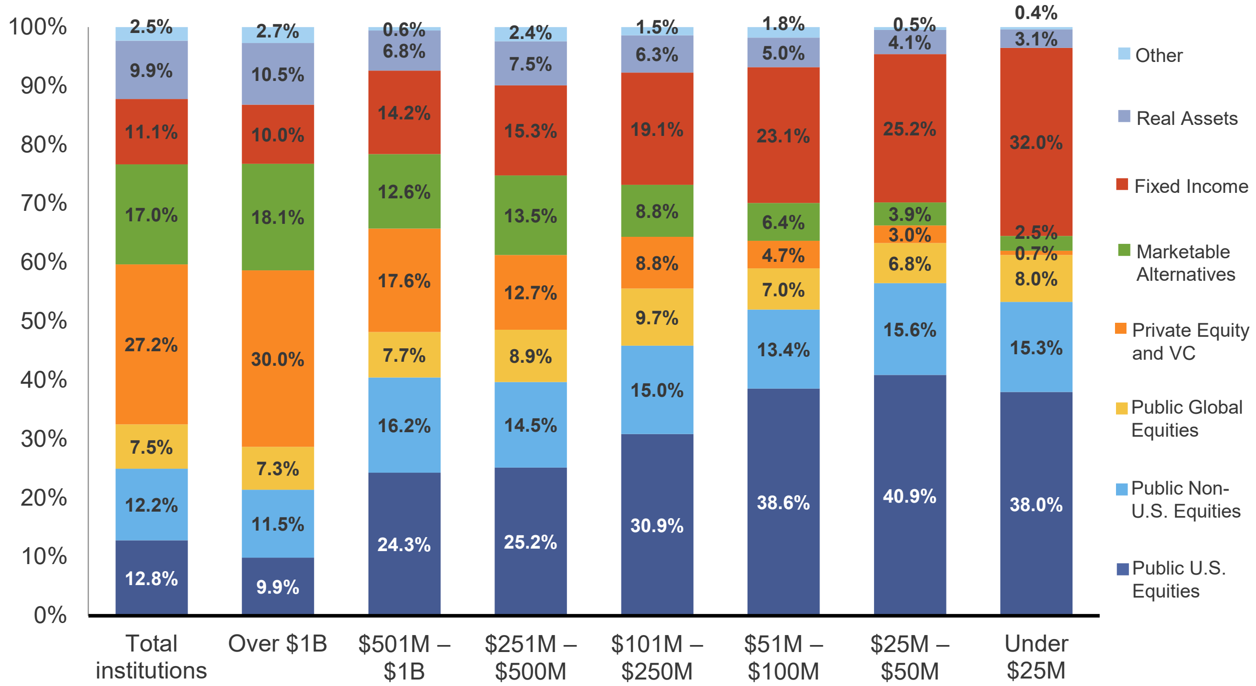


2021 NTSE.

Asset Allocation

On average, institutions allocated nearly 54% to alternative investments such as private equity, venture capital, real assets, and marketable alternatives, in line with recent years. The allocation to alternatives at the expense of traditional assets such as public equities and fixed income remains significantly higher at larger endowments. For example, endowments with over $1 billion had 30% of their assets in private equity and venture capital, while their smaller counterparts with $25 – $50 million had only 3% in these asset types. This benefited the larger institutions in FY2021, where the median yearly return for endowments with over $1 billion in assets was 36.5%, compared to 28.1% for the year endowments with $25 – $50 million in assets.

Asset Allocation by Endowment Size (FY2021)



2021 NTSE.

Responsible Investing and DEI Initiatives

In FY2021, 47.4% of endowments factored responsible investing into their investment manager evaluation process, an increase from the 39.6% level of FY2020. Additionally, 26.1% of survey respondents now believe that ESG can be a source of alpha, an increase from the 19.4% of respondents the prior fiscal year. Actual implementation is slowly forthcoming, however, as ESG faces setbacks in its adoption, including a lack of standardized ESG reporting.

On diversity, equity, and inclusion (DEI) initiatives, 65% of respondents voiced that some level of gifts in FY2021 were tagged to support DEI initiatives. Additionally, the number of institutions reporting they had a formal DEI policy relating to manager selection increased to 7.7% in FY2021 from 5.8% the prior fiscal year. Private institutions entirely drove this increase.

Our View

As we continue to face an evolving and uncertain market environment, with an expectation of challenged investment returns over the intermediate-term, we believe that it is important for institutions to remain up to date with their investment and spending policies. Here are a few considerations in view of the latest NTSE study:

- Given the average endowment continues to underperform a traditional 60/40 index over the long-term, investors may consider defaulting to low-cost passive investments in more efficient asset classes, such as domestic large-cap and developed international equities.
- Due to the higher fees associated with alternative investments, the difficulty accessing top tier managers, and the wide dispersion of returns between top and bottom quartile managers, institutions need to carefully weigh the potential costs and benefits of allocating in this asset class.

- Institutions still relying on a 12-quarter spending policy smoothing period may consider changing to 20 quarters or 7-year smoothing. Our studies show that a longer smoothing period leads to more balanced outcomes.[2]
- With the pressure to raise return requirements to help offset fees and inflation, as well as reduced expected returns from fixed income in a rising interest rate environment, institutions may consider reducing their spending and expenses, or optimizing their asset allocation based on the latest capital market assumptions.
- Regarding DEI and the inclusion of minority managers in an investment portfolio, we feel there may be barriers inadvertently placed on minority managers, excluding them from typical manager searches, while endowments may benefit from including these managers.[3]

PFMAM stands ready to provide investment advice and solutions to our endowment, foundation, non-profit and other institutional clients in this dynamic investment environment. And we look forward to learning more about your organization and how we can serve you.

2 *Please read our previous InvestEd about spending policy, Spending Policy 2.0: Understanding the Historical Impact of Spending Calculation Rules on Endowments (From 1970 to 2020).*

3 *Please read our previous InvestEd about minority managers and ESG, Multi-Asset Class Minority Manager Investing.*

For more information, please email our Endowments & Foundations National Practice at EFNP@pfmam.com or contact your PFMAM representative.

All data from the 2020 NACUBO-TIAA Study of Endowments (NTSE) unless otherwise noted.