Quarterly Market Update

A partnership between the Association of Small Foundations (ASF) and U.S. Trust, Bank of America Corporation to provide quarterly investment analysis for small-staff philanthropists

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Financial stewardship is a key focus for boards, investment committees, donors, and beneficiaries. This has been especially true over the past 6 years—a tumultuous period that included a dramatic market downturn that rattled the cages of almost every philanthropic organization, causing many to question the foundational principles governing grantmaking, mission support, and prudent investment policies. We also see an increase in financial concern due to current events in the markets, driven as much by Washington as by Wall Street and Main Street. So, how are we—as stewards of our organizations' assets—to cope with this dizzying array of news and financial reports? How much is relevant to us, to our mission, and to our constituents? And, what actions should we be taking to help guard against potential losses, while also taking advantage of potential opportunities? A key question on the minds of many has been, How will we restore the value that was lost from our investment portfolio in the crash of 2008? Our Quarterly Market Update will help you make sense of what's been happening in the financial markets, allowing you to focus on key ideas that are relevant to you with an eye toward helping you position your investment portfolio to meet your specific financial goals. This edition reviews both the year 2013 as well as the spectacular recovery that occurred in the markets during the past 5 years.

Following very strong returns in the third quarter of 2013, the investment markets once again posted strong returns in the fourth quarter. Global equities earned 8.75% for the quarter, with its individual components ranging from a lowest return of 2% (MSCI Emerging Markets Index) to a highest return of 10.5% (S&P 500 index.) Within the U.S. economy, we saw positive returns across all economic sectors of the S&P 500 index, from a low of just below 2% in utilities to a return of nearly 13% for industrials. Performance between "growth" and "value" stocks (as measured by the Russell 1000 Growth and Value indices) was generally equal, while larger company stocks outperformed mid- and small-size company stocks by about 2% for the quarter (as measured by the Russell Midcap Index and Russell 2000 Index, a small-cap index). Meanwhile, global bonds (equally allocated between the Barclays Capital Aggregate Index and Citigroup World Government Bond Index) lost about half a percent this quarter. The steepest losses were in U.S. Treasury bonds that lost almost 2.5%, with foreign bonds losing about half as much. The only bright spot for bonds was domestic high yield (as measured by the Barclays Capital High Yield Index), which gained over 3.5% on the coattails of the strong equity rally. This is as expected for bonds in the "spread sectors," which have exposure to the economy; these provide a welcome hedge to the losses caused by rising interest rates as economies improve.

The alternatives sector provided modest returns for the quarter, led by hedge funds (as measured by the Credit Suisse Hedge Fund Index) earning over 4%, while real estate (as measured by the FTSE/NAREIT All REITs Index) held its ground, earning just 30 basis points. Commodities (as measured by the Dow Jones/UBS Commodities Index) continued the recent trend of poor performance, losing over 1% for the quarter. The value of diversification was once again evident, as we saw a portfolio of alternatives split equally between hedge funds and real assets earning nearly 2% in Q4.

Consider a hypothetical portfolio that was diversified globally across public equity (60% in MSCI World Index) bonds (30% allocated as 27% high quality and 3% high yield) and alternatives (10% allocated as 5% hedge funds, 2.5% real estate, and 2.5% commodities). This portfolio would have earned about 5.3% in Q4 2014 in spite of pockets of weakness in all asset classes. Once again, this demonstrates the value of broad diversification as a means of protecting and preserving both capital and liquidity while reaching for market opportunities to help to grow the portfolio over the long term.

Annual Returns for 2013

2013 was a spectacular year for investors who maintained their discipline and remained invested with an emphasis on equities. This was even more the case for those who followed guidance to

move capital away from bonds and into stocks, and who favored the largest segment of the U.S. stock market. Additionally, emphasizing shorter maturity corporate bonds helped to lessen bond losses. This strategy provided both a strong market return in addition to a tactical strategy return from short-term asset allocation shifts. In total, this produced the strongest return in the 5 years of market recovery following the 2008 downturn. As we will show, a portfolio that maintained its "70/30" asset strategy over this period would have fully recovered its value prior to the downturn of 2008 while continuing to support its mission through its spending program.

Equities

In 2013 the U.S. equity market produced returns of 32% (large stocks), 35% (mid-sized stocks), and 39% (small stocks) for a total return of 33.5%. Foreign equity markets earned 23% (developed countries) and -2% (emerging economies) for a total return of 13%. In total, this global equity portfolio earned almost 27% in 2013 (as measured by the MSCI World Equity Index).

Bonds

U.S. bonds faced losses that more than wiped out their relatively low levels of coupon interest income, producing modest losses for the year. This is expected at a time of rising interest rates, largely driven by the market's reaction to the Federal Reserve's plan to begin tapering off its plan to buy mortgages in its efforts to keep interest low as a stimulus to the economy. Treasury bonds were hit the hardest by price declines while "spread sectors," such as corporates, mortgages, and high yield, had offsetting gains in response to positive equity returns. Ten-year Treasury bonds lost almost 8% in 2013 while corporate and mortgage bonds lost 1.5% (as measured respectively by the Barclays Capital Corporate and Mortgage indices.) The Barclays Aggregate Index, which represents the broader bond market of treasuries, corporates, and mortgages lost 2% for the year. Benefiting from the strong rally in equities, the High Yield Index gained nearly 7.5%. Once again demonstrating the benefits of diversification, our bond benchmark of 90% high quality and 10% high yield would have lost only 1% in 2013, cutting bond losses in half.

Alternatives

Commodities produced significant losses in 2013, losing 9.5% of their value. Real estate earned a modest return of 3.25% while hedge funds earned almost 8.5%. An alternatives mix with half invested in hedge funds, with the remainder split equally between real estate and commodities, would have earned a modest return of over 2.5% in 2014.

Our hypothetical diversified portfolio as described earlier of 60% public equity, 30% bonds, and 10% alternatives would have produced a return of almost 16% in 2013, making this the best return of the 5-year recovery following the 2008 market downturn.

Economic and Market Outlook

The global slowdown that began in 2011 ended a year ago. Since then, U.S. profit growth has accelerated, and we see a pickup in global growth. This should drive revenues and profits. Although we would expect to feel a squeeze from rising wages and higher interest rates, this is relatively modest, given the low levels of wage gains and interest rates. We see that labor is a decreasing share of the cost structure of the U.S. economy, and a greater use of capital translates to higher profit margins. A solid U.S. economy has been an anchor for the rest of the world, and we expect to see European markets recover. Rising worldwide profits should spur companies to invest and hire, stimulating more growth.

Portfolio Strategy and Asset Allocation

- We remain **overweight equities.**
- We remain **overweight U.S. markets** and expect the U.S. market to lead global growth, outperforming other asset classes.
- We are tactically **underweight in emerging markets.**
- Within domestic equities, we remain **overweight large caps** due to their greater exposure to global growth.
- We remain **overweight international developed equities.**
- We remain **underweight fixed income.**
  - We recommend **reducing duration** to protect the portfolios in a rising-interest-rate environment.
  - Within fixed income, we continue to **prefer credit** to treasuries, with an emphasis on corporate bonds and mortgage-backed securities (MBS).

- We recommend a **more active management** approach in fixed income to maximize potential returns in a rising rate environment.
- We maintain our **neutral weight to global high yield.**

- We are **underweight commodities.** The tangible asset class is likely to face "tapering" headwinds as it has a high correlation to financial liquidity conditions.
- We remain **underweight hedge funds** based on our view that directional asset classes would perform better as the U.S. economy gains momentum.
- We remain **overweight real estate** as the housing recovery gains momentum.

There and Back Again: From the Dreaded Downturn of 2008 to the Marvelous Recovery Through 2013

A persistent question in the minds of many stewards of charitable portfolios has been, Have we recovered the value we had prior to the 'crash' in 2008?

Happily, the answer is *yes!*

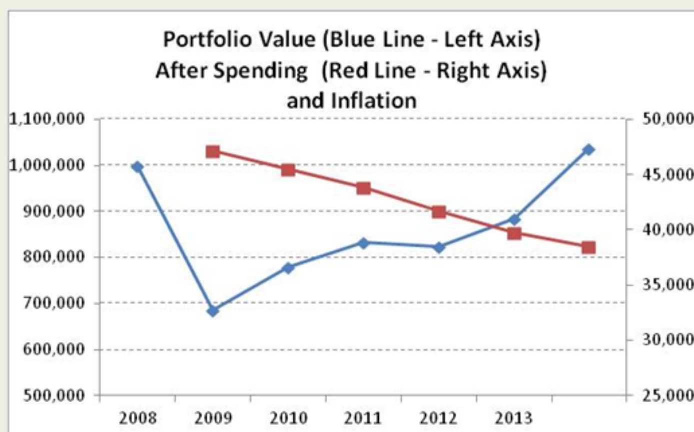
The three challenges we have faced during this recovery period have been:

- The low portfolio value following the substantial market downturn in 2008
- Maintaining spending at a 5% rate through substantial market turbulence
- Inflation of about 2% per year—low, but still an additional "headwind"

We will illustrate using a simple portfolio strategy that remains invested in a mix of 70% S&P 500 and 30% Barclays Aggregate Bonds. Spending is at a 5% rate applied to the average of the prior 5 years' market value. We assume that the portfolio had kept up with inflation, net of spending in the 4 years prior to the beginning of 2008.

These simulated results show that we accomplished our primary responsibility of preserving the real value of the portfolio net of spending and inflation. In fact, the portfolio ends the 5-year recovery with a slight surplus to its preserved minimum value.

We also see that spending was automatically moderated (in dollar terms) as the 5% spending rate was applied to an average balance that followed a declining trend. This modest moderation of relative spending (about 4% each year) helped the portfolio to accumulate more of its market gains for the purpose or restoring the target value. We expect the trend of spending to reverse in coming years as the average portfolio turns positive. This demonstrates the "virtuous cycle" of building portfolio value in strong years so that spending can be sustained in weak years.



Year	Portfolio	S&P 500	BC Agg	3-month T.Bill	Inflation
2008	-26.1%	-36.6%	5.2%	1.6%	3.9%
2009	20.9%	25.9%	5.9%	0.1%	-0.3%
2010	12.7%	14.8%	6.5%	0.1%	1.6%
2011	3.5%	2.1%	7.8%	0.0%	3.2%
2012	13.0%	15.9%	4.2%	0.1%	2.1%
2013	23.6%	32.2%	-2.3%	0.1%	1.5%
Return	***6.5%***	***6.2%***	***4.5%***	***0.3%***	***2.0%***

Hypothetical Portfolio, For Illustrative Purposes Only

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- A portfolio of stocks and bonds (70% S&P 500 and 30% BC Aggregate) that began with $1 million in 2008 lost over 30% of its value in 2008 as a result of spending through the year's market downturn.

- The discipline of applying the 5% spending rate to an average of the prior 5 years' market values caused real spending to decline smoothly by about 4% on a relative basis each year over the following 5 years.

- The goal of inflation-adjusted spending each year was to provide a total of about $283,000 in spending over this 6-year period. The portfolio was able to achieve over 91% of this goal in spite of market declines, providing over $256,000 in total spending.

- This moderation in spending helped the portfolio to recover its real value over the next 5 years, increasing to over $1,036,500 in 2008 dollars. The portfolio now has a modest surplus of over 3.5%.
- This provides a valuable lesson in the *three ingredients of success* that we have discussed this year:
  - Align the investment strategy and its expected return to the spending rate.
  - Exercise discipline in maintaining both investment strategy and spending throughout market cycle.
  - Evaluate success in terms of the goals of preserving the real value of the portfolio assets (primary) and providing sustainable spending toward the mission (secondary).

Insights From Our 2013 Quarterly Market Updates

Q1: The Endowment Challenge

- A decline in global markets produced substantial losses across all asset classes.
- Many foundations questioned their ability to continue to "meet the mission."
- Fiduciaries put increased emphasis on key elements of long-term investment success:
  - Setting a sustainable spending policy
  - Aligning investment strategy to the spending rate
  - Executing the investment plan with skill to manage risk and increase return
  - Evaluating success in terms of the mission
- Recovery of assets following a downturn requires sticking to the investment discipline.

Q2: Separating News From Noise

- Fiduciary responsibility starts with risk management:
  - Reputational risk
  - Mission risk
  - Asset risk
  - Spending risk
  - Portfolio value risk
- Fiduciaries must look to their investment providers for guidance on investments. This requires:
  - Separating the relevant information from the huge mountain of news
  - Considering all information in the context of fiduciary decision making
- We noted the trend toward outsourcing investments under the OCIO (outsourced chief investment officer) model
  - Investment management requires substantial resources that may exceed a foundation's resources
  - Outsourcing frees up an organization's fiduciaries to concentrate on their "highest/best uses": setting goals, oversight, fundraising

Q3: Making Sense of Market Uncertainty and Volatility

- Market ups and downs provide opportunities to:
  - Preserve capital by moving assets away from areas of higher expected downside risk
  - Grow capital by moving assets toward areas of increased expected opportunity
- Tactical asset allocation is an important source of extra return; this is important when we anticipate weak market returns.

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- This approach turns market volatility into a potential opportunity for increased return, but this depends on a disciplined investment process and adequate risk controls.

Q4: The Road to Recovery

- The investment market may experience severe, short-term downturns, such as in 2008.
- Investment planning should help provide surpluses in strong years that sustain the mission in weak years.
- Investment discipline is required to maintain the strategy through the recovery.
- A significant risk is abandoning the strategy prior to a recovery.
- Disciplined investors have recovered from 2008's downturn after a 5-year period of growth.
- Keys to recovery: devotion to mission, disciplined diversification, skillful execution, watchful care

Source: All data provided by U.S. Trust® Office of the Chief Investment Officer and Portfolio Analytics and Consulting, January 6, 2014.

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