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Have endowments found a place to hide?

US endowments keep outperforming

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Summary

- While the fiscal year that ended on June 30 2022 (FY2022) was challenging for US endowments, figures show they fared relatively better than bonds and equities and thus outperformed 60/40 portfolios.
- Large endowments (those worth over USD1 bn) did much better than smaller ones, due essentially to their larger allocations to alternative assets like private equity, real assets and hedge funds and their low exposure to bonds. Indeed, endowments' important exposure to alternative assets, especially real assets, cushioned the market shock experienced by stocks and bonds in 2022.
- The FY2022 figures show that US endowments continue to rely on alternative assets to boost long-term returns.
- Despite endowments' negative performance in FY2022, annual returns for US endowments over the past 10 years, especially for large ones, still look enticing when set beside standard 60/40 portfolios.
- US endowments are pencilling in average annual returns of above 8% over the next 10 years. While this is higher than our own expectations, endowments still look attractive over the long term when compared with 60/40 portfolios.

LOW LIQUIDITY NEEDS ENABLE ENDOWMENTS TO TOLERATE RELATIVELY HIGH SHORT-TERM VOLATILITY

Endowments are pools of capital set up on behalf of non-profit organisations and funded through gifts and donations. Many institutions, particularly in the US, have endowments, including universities, museums and hospitals. The history of endowment funds dates back to the 16th century when kings and wealthy families set up trusts to ensure their wealth was passed down through generations. In the 18th century, universities began creating endowments to support their academic and infrastructure programmes. At present, the largest funds are held by American universities – led by Harvard University (USD49.4 bn of assets under management (AUM) at end-June 2022), followed by the University of Texas System (USD42.7 bn) and Yale University (USD41.4 bn). Established in the early 18th century, the Yale endowment fund is one of the oldest and most successful in the world.

> "Fiscal year 2022 was an extremely challenging one for endowments"

The primary investment objective of university endowments is to generate sufficient returns to maintain the purchasing power of their assets in perpetuity for future generations and to sustain the level of spending necessary to support the university's operating budget.

Low liquidity needs enable endowments to tolerate relatively high short-term volatility and focus on the long-term pursuit of superior returns. As a consequence, many university endowments, particularly the large ones (those with AUM of over USD1 bn), have relatively high allocations to equities and private assets and smaller allocations to fixed income than classic investment portfolios.

NEGATIVE FY2022 RETURNS, BUT ENDOWMENTS STILL OUTSTRIPPED 60/40 PORTFOLIOS

Fiscal year 2022 (FY2002, which ended on 30 June 2022) was an extremely challenging one for endowments. Rising interest rates and inflation as well as acute geopolitical tensions meant that, accordng to NACUBO-TAA, in FY2022 endowment funds recorded an average negative return of 8% (all institutions, irrespective of size, in US dollars) – a sharp comedown from the average gain of 30.6% seen in fiscal year 2021. Yet this is not a bad result given the dramatic decline

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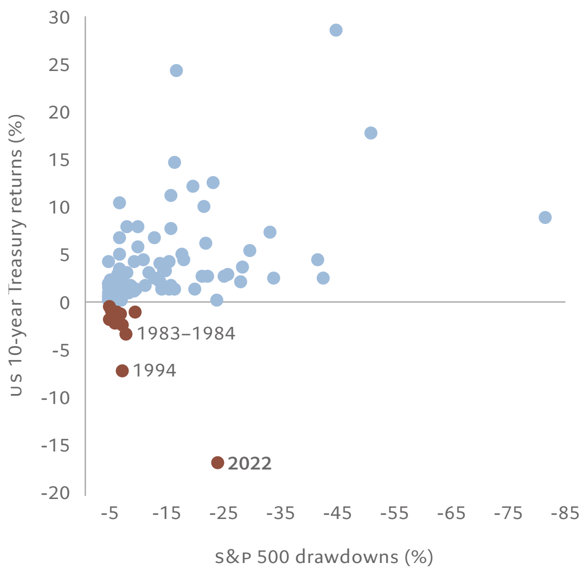
in both equity and bond markets, with the S&P 500 Index and 10-year US Treasuries alike tumbling by over 10% in the 12 months to 30 June 2022 and by 24% and 17%, respectively during calendar year 2022 (*see chart 1*). With bonds failing to cushion for losses in equities, a hypothetical US 60/40 portfolio (60% S&P 500, 40% 10-year US Treasuries) would have lost 10.5% and a global 60/40 portfolio (60% MSCI AC World, 40% Bloomberg Global Treasury) would have dropped 15.7% in FY2022.

Equity markets have generally improved since. In the eight months to end February, the S&P 500 rose 6.0% and the MSCI AC World by 7% (in US dollars), while the Bloomberg Global Aggregate bond index declined by 3% and 10-year US Treasuries lost 6%. Based on their allocations and returns for public assets, we estimate that US endowments gained an average of around 4% between 1 July 2021 and 28 February 2022. To estimate returns on private assets, we rely on sensitivity analysis (using beta) relative to public assets.

CHART 1

Performance of US 10-year Treasuries vs. S&P 500 index during equity drawdowns (the years indicated in the chart are calendar years)



Source: Pictet Wealth Management, JP Morgan, FactSet, February 2023

Large endowments (over USD1 bn in AUM) performed comparatively better than endowments as a whole in FY2022, losing only 4.5%. The heavy allocation of large endowments to alternative assets (including private equity, hedge funds and real assets) and the ongoing reduction of their exposure to bonds paid off again. Of the 678 US endowments surveyed by NACUBO-TIAA, 13 actually achieved a positive return of at least 1.3% – an excellent result in light of the volatility seen in financial markets in 2022.

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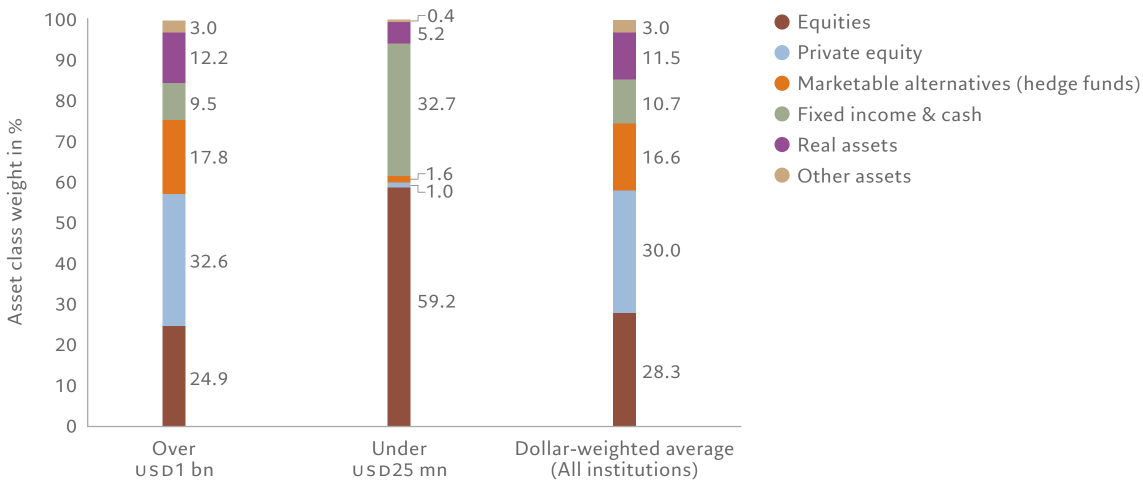
According to NACUBO-TIAA figures, in FY2022 large US endowments allocated 25% of their assets to US and non-US equities, 8.5% to fixed-income assets and cash, and around 64% to alternatives including private equities, private debt, real assets and hedge funds (*see chart 2*). The allocation of large endowments to private equity (buyout and venture capital funds) increased from 30% to 33% in FY2022 from a year before while real assets grew from 10.5% to 12.2%. The growth in the private-assets allocation was likely driven by the relative resilience they showed in the face of the downturn in public markets in FY2022. Overall, large endowments in particular continue to rely on private assets to achieve superior long-term returns.

CHART 2
Average asset allocation for large and small endowment funds as of 30.06.2022



Source: Pictet Wealth Management, NACUBO-TIAA Study of Endowments, February 2023

Smaller endowments (those with an AUM of under USD25 mn) were the worst performers in FY2022, returning -11.5% – but they still outperformed global 60/40 portfolios (-15.7%). Smaller endowments have around 60% exposure to US and non-US equities according to NACUBO-TIAA and around 33% to fixed income, with the rest allocated to real assets and hedge funds.

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REAL ASSETS AND PRIVATE EQUITY CUSHIONED ENDOWMENTS' LOSSES IN STOCKS AND BONDS

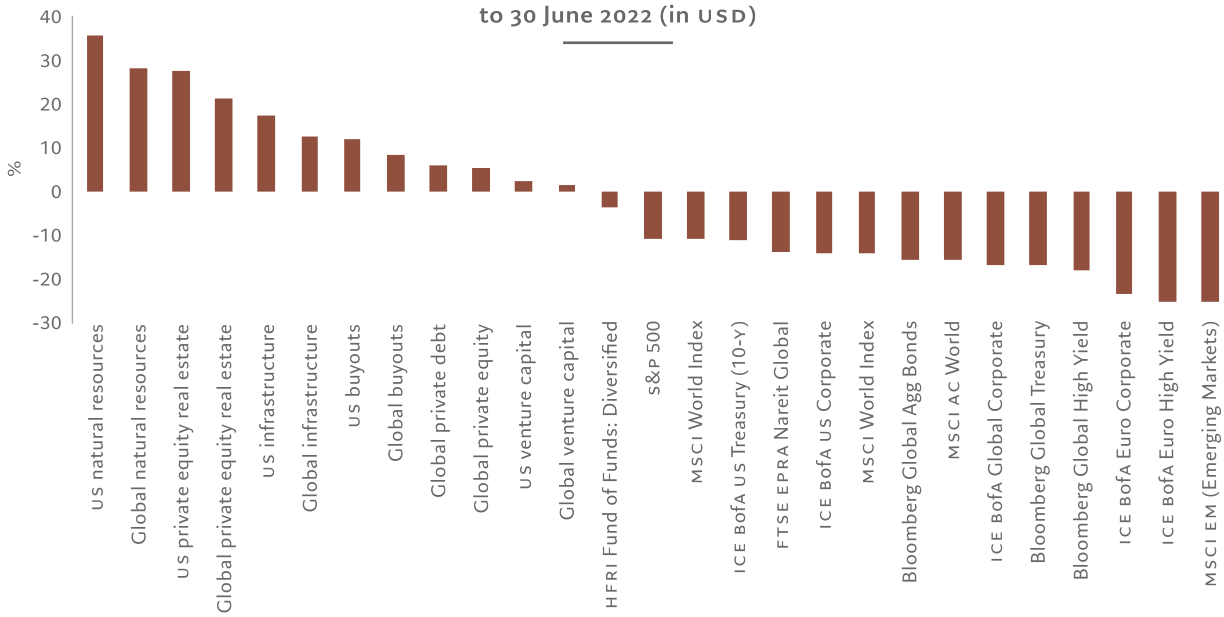
Large endowments therefore owe their superior relative performance to their high allocation to alternative assets and low exposure to fixed income. Large endowments have reduced their exposure to fixed income over time and increased their allocation to alternative assets. While losses in equities were mitigated by the resilient performance of real assets and private equity in FY2022, bonds had a comparatively low impact on endowment funds' overall performance.

> "The best-performing assets for endowments in FY2022 were real assets"

The best-performing assets in FY2022 were real assets (natural resources, private real estate and infrastructure), followed by private equity and hedge funds. Hedge funds suffered negative returns, but much less than equities and bonds (*see chart 3*). Indeed, some endowments reported a good performance from their hedge fund investments as individual strategies like macro delivered strong returns in FY2022.

CHART 3

Total returns for asset classes in year to 30 June 2022 (in USD)



Source: Pictet Wealth Management, FactSet, Burgiss, February 2023

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Private assets are only suited for large or professional investors with: (i) a long-term investment horizon (>10 yrs); (ii) no liquidity requirements; and (iii) an understanding of the risks linked to this asset class.

Overall, one observes that endowments' large exposure to private equity, real assets and some hedge-fund strategies helped cushion the impact of the dramatic fall in equities and bonds.

LONG-TERM RETURNS REMAIN RESILIENT DESPITE DISAPPOINTING FY2022

Endowments aim to maintain the purchasing power of the institutions to which they belong and provide sufficient returns to support these institutions' operating needs in perpetuity. Therefore, it makes more sense to look at endowments' performance over the long term rather than in a single fiscal year.

Despite FY2022's negative returns, endowments' long-term annualised returns remained close to their long-term target. For all endowments, irrespective of size, the average 10-year annualised return stood at 7.8% at 30 June 2022, down from 8.5% a year before. For large endowments (over USD1 bn in AUM), the average 10-year annualised return decreased from 9.4% in FY2021 to 8.9% in FY2022. A standard US 60/40 portfolio would have returned an average 8.3% and its global version 5.8% over the same 10-year period. Large US endowments have produced an annualised return of 9.8% over the past 30 years – the same as the S&P 500 (but with much lower volatility) and 160 basis points more than a US 60/40 portfolio (*see table*).

Endowments' average returns over different time periods (in %)

ENDOWMENTS BY SIZE	1-YEAR	3-YEAR	10-YEAR	30-YEAR	50-YEAR
Large endowments (Over USD1 bn)	-4.5%	10.5%	9.4%	8.9%	9.8%
Over USD500 mn to USD1 bn	-5.7%	8.5%	7.8%	7.9%	8.4%
Over USD250 mn to USD550 mn	-7.8%	7.7%	7.2%	7.6%	-
Over USD100 mn to USD250 mn	-9.0%	6.8%	7.0%	7.8%	-
Over USD50 mn to USD100 mn	-9.7%	5.8%	5.9%	6.9%	-
Over USD25 mn to USD50 mn	-10.7%	5.4%	6.2%	7.1%	-
USD25 mn and under	-11.5%	4.4%	5.5%	7.1%	-
All institutions	-8.0%	7.5%	7.3%	7.8%	7.6%
US 60/40 *	-10.7%	6.2%	7.3%	8.3%	8.2%
Global 60/40 **	-15.7%	2.7%	4.4%	5.5%	6.7%

Source: Pictet Wealth Management, 2022 NACUBO-TIAA Study of Endowments, Bloomberg, FactSet, February 2023
* US 60/40: mix of 40% of US 10-year Treasuries and 60% of S&P 500 index
** Global 60/40: mix of 40% of Bloomberg Global Treasury Index and 60% of MSCI AC World index

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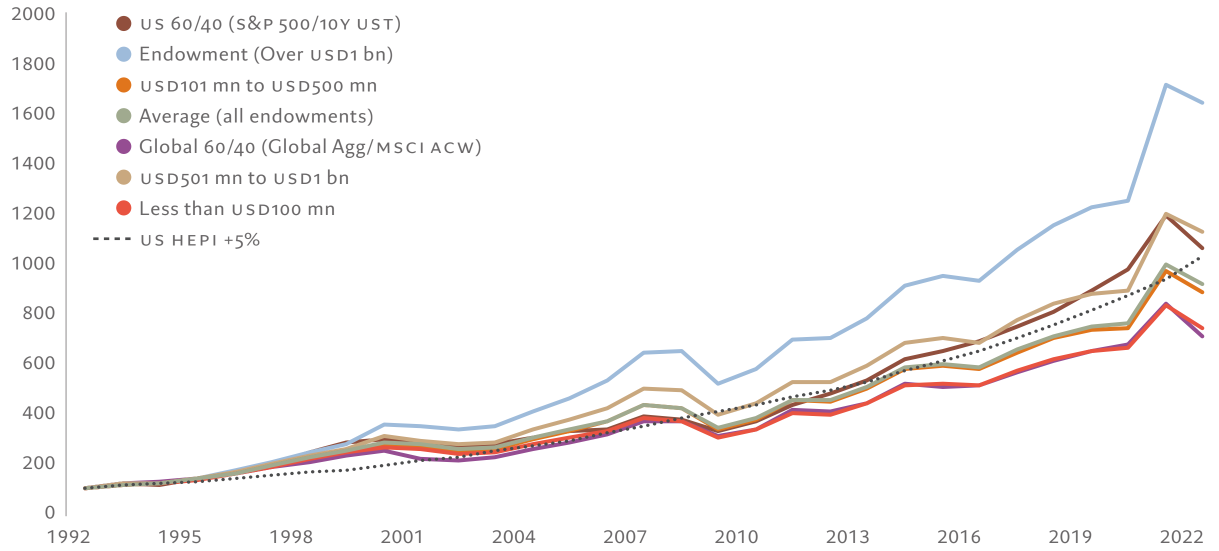
CHART 4

Endowment funds' cumulative returns vs. 60/40 portfolios and HEPI +5%, 1992–2022



Source: Pictet Wealth Management, 2022 NACUBO-TIAA Study of Endowments, FactSet, February 2023

In general, endowments target an average long-term net return (net of fees and adjusted for inflation) of 5% (HEPI +5%). The Higher Education Price Index (HEPI) that university endowments use as a measure of inflation is generally higher than the commonly used Consumer Price Index (CPI). As *chart 4* shows, only the large endowments (those with an AUM of USD500 mn) have consistently met or exceeded the HEPI +5% target over the past 30 years. This result can be explained by their higher exposure to alternative assets and their privileged access to skilful active managers to add alpha.

"Endowments generally target an average annual real return of 5% after inflation"

1 Risk-adjusted return is calculated as the annualised return divided by the annualised volatility.

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MEETING RETURN TARGETS OVER THE NEXT 10 YEARS WILL BE A REAL CHALLENGE

According to NACUBO-TIAA, endowments are targeting average annual returns of 8.2% over the next 10 years, compared with a previous target of 7.9%. This increase is mainly due to higher annual inflation expectations, which have gone from 2.3% to 2.45% as well as a 12 bp hike in annual fees and expenses to 1.16%. Achieving this target will be a real challenge for endowment managers. Our own expectations are for an average annual return of 5.6% (in USD) for all endowments, with the largest funds returning an average of 6.4% over the next 10 years. This is much lower than the endowments' own target. Nevertheless, endowments still look attractive compared with a standard US 60/40 portfolio, which is expected to deliver an annual return of 4.3% over the same period (these forecasts are based on the expected return calculations we published in the 2022 edition of *Horizon*).

> "Endowments still look more attractive over the long term than standard 60/40 portfolios"

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Total returns for public assets and indexes over the past five calendar years

PUBLIC INDEXES	2022	2021	2020	2019	2018
ICE BofA Current US Treasury (10-Y)	-16.3%	-3.7%	10.6%	8.9%	0.0%
Bloomberg Global Treasury	-17.5%	-6.6%	9.5%	5.6%	-0.4%
Bloomberg Global High Yield	-12.7%	1.0%	7.0%	12.6%	-4.1%
Bloomberg Global Aggregate	-16.2%	-4.7%	9.2%	6.8%	-1.2%
ICE BofA Euro High Yield	-16.9%	-3.9%	12.0%	9.3%	-8.2%
ICE BofA Global Corporate	-16.7%	-3.0%	10.3%	11.4%	-3.5%
ICE BofA US Corporate	-15.4%	-1.0%	9.8%	14.2%	-2.2%
ICE BofA Euro Corporate	-19.2%	-8.0%	11.9%	4.3%	-5.9%
S&P 500	-18.1%	28.7%	18.4%	31.5%	-4.4%
MSCI EM (Emerging Markets)	-19.7%	-2.2%	18.7%	18.9%	-14.2%
MSCI World Index	-17.7%	22.3%	16.5%	28.4%	-8.2%
MSCI AC World	-18.0%	19.0%	16.8%	27.3%	-8.9%
HFRI Fund of Funds: Diversified	-3.1%	5.9%	10.6%	8.1%	-3.3%
FTSE EPRA Nareit Global	-23.6%	23.0%	-9.2%	23.6%	-5.5%
PUBLIC ASSETS					
US buyout	-2.0%	41.0%	23.0%	18.0%	12.0%
US private equity real estate	7.0%	32.0%	0.0%	9.0%	9.0%
Global buyout	-5.0%	37.0%	24.0%	17.0%	9.0%
Global private equity real estate	3.0%	26.0%	1.0%	8.0%	7.0%
Global private equity	-8.0%	40.0%	34.0%	18.0%	12.0%
Global venture capital	-14.0%	49.0%	56.0%	19.0%	21.0%
Global infrastructure	4.0%	13.0%	7.0%	8.0%	8.0%
Global natural resources	15.0%	30.0%	-9.0%	-5.0%	-3.0%
Global private debt	0.0%	16.0%	6.0%	8.0%	5.0%
US venture capital	-16.0%	61.0%	61.0%	21.0%	20.0%
US infrastructure	9.0%	17.0%	4.0%	5.0%	5.0%
US natural resources	21.0%	36.0%	-13.0%	-6.0%	0.0%

Source: FactSet, Burgiss, February 2023

Total returns for US endowments of various sizes over the past five fiscal years (ending on 30 June)

ENDOWMENTS	FY2022	FY2021	FY2020	FY2019	FY2018
Over EUR1 billion	-4.5%	37.3%	2.5%	5.9%	9.7%
EUR501 million to EUR1 billion	-5.7%	33.9%	1.5%	5.1%	8.7%
EUR251 million to EUR500 million	-7.8%	31.5%	1.3%	5.0%	8.5%
EUR101 million to EUR250 million	-9.0%	28.9%	1.6%	5.0%	8.3%
EUR51 million to EUR100 million	-9.7%	26.6%	1.8%	5.1%	7.9%
EUR25 million to EUR50 million	-10.7%	27.3%	1.9%	4.9%	7.7%
Under EUR25 million	-11.5%	23.9%	2.5%	5.5%	7.5%
All Institutions	-8.0%	30.6%	1.9%	5.8%	7.6%

Source: NACUBO-TIAA Study of Endowments, February 2023

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