

# CFC 2011 Conference A World of Opportunity



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OF CANADA  
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## Investing Trends for Foundations

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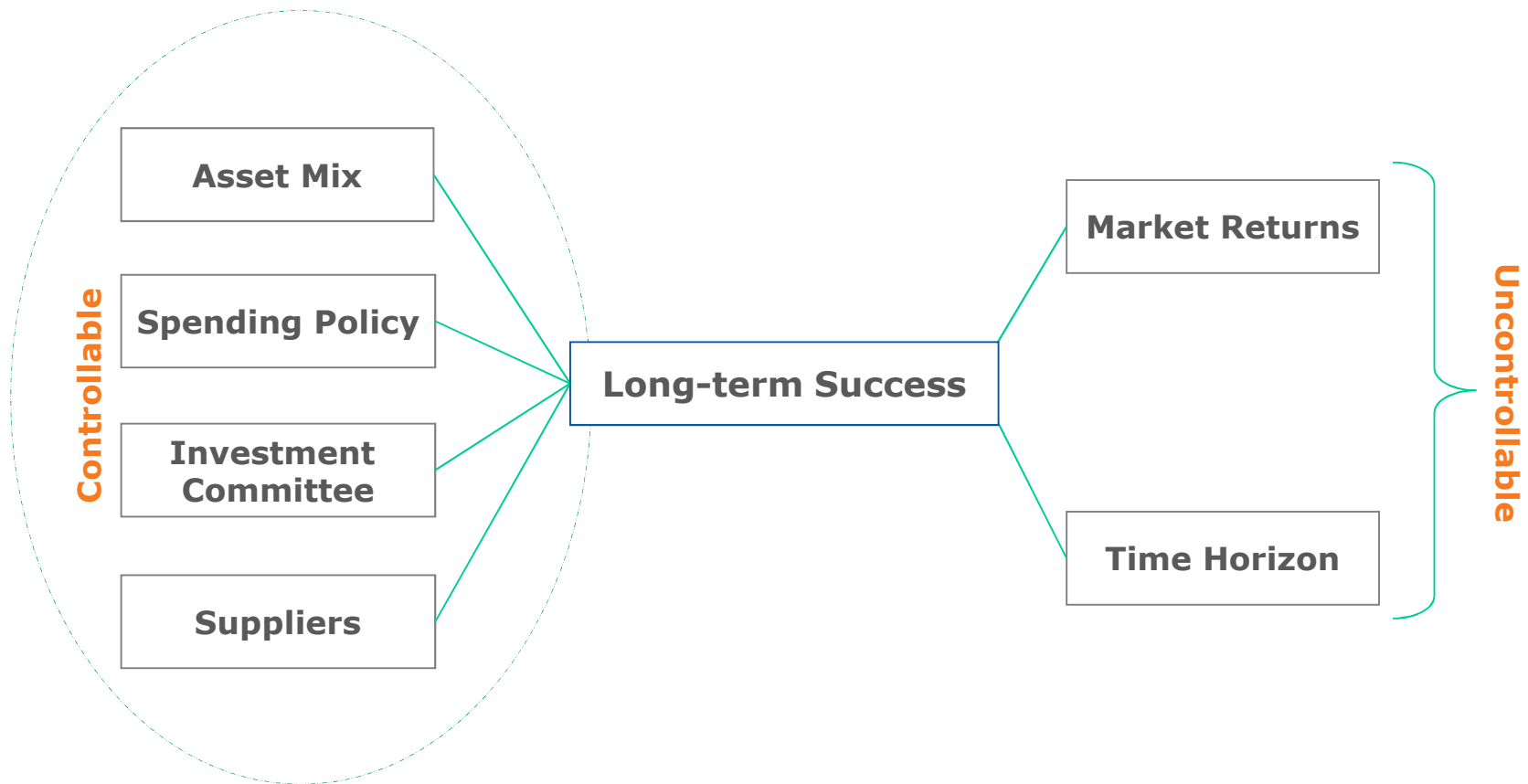
# Investing Trends for Foundations

## Topics for Discussion

- > Managing controllable factors
  - > Keys to success
- > Financial Crisis and Recovery
- > Crisis impact on charitable giving
- > Spending policy and asset mix
- > Investment return expectations
- > Asset class and manager selection
  - > Behavioral biases
- > Increasing probabilities for long-term success

# Key Success Factors

Variables



# Investor Psychology - Confidence Test

## A brief experiment

For each of the following ten items, provide a low and high guess such that you are 90 percent sure the correct answer falls between the two.

| Question   | Low | High | Units  |
|--|-----|------|--------|
| 1. Martin Luther King's age at death               |     |      |        |
| 2. Length of the Nile River                        |     |      | Miles  |
| 3. Number of countries that are members of OPEC    |     |      |        |
| 4. Number of books in the Old Testament            |     |      |        |
| 5. Diameter of the moon                            |     |      | Miles  |
| 6. Weight of an empty Boeing 747                   |     |      | Pounds |
| 7. Year in which Wolfgang Amadeus Mozart was born  |     |      |        |
| 8. Gestation period (in days) of an Asian elephant |     |      |        |
| 9. Air distance from London to Tokyo               |     |      | Miles  |
| 10. Deepest (known) point in the oceans            |     |      | Feet   |

Source: Confident Decision Making, J. E. Russo & P. J. H. Schowmaker, 1989, Piatkus, London p 71

# Investor Psychology - Trend Spotting

## A brief experiment

- > Over 6 coin tosses, is a sequence of 1) HTHTTH more likely, less likely or the same likelihood as a sequence of 2) HHHTTT

- a) More likely
- b) Less likely
- c) The same

Source: Aspects of Investor Psychology Beliefs, preferences, and biases investment advisors should know about, Daniel Kahneman Princeton University, Mark W. Riepe Charles Schwab and Co. Inc Journal Of Portfolio Management, Vol. 24 No. 4 Summer 1998

# Investor Psychology – Risk and Loss Aversion

## A brief experiment

- a. You have a choice of a sure \$50 gain or, with a flip of a coin, winning \$100 or getting nothing. What is your choice?

Take the \$50 gain  or flip the coin

- b. You have a choice of a sure \$50 loss or, with a flip of a coin, losing \$100 or losing nothing. What is your choice?

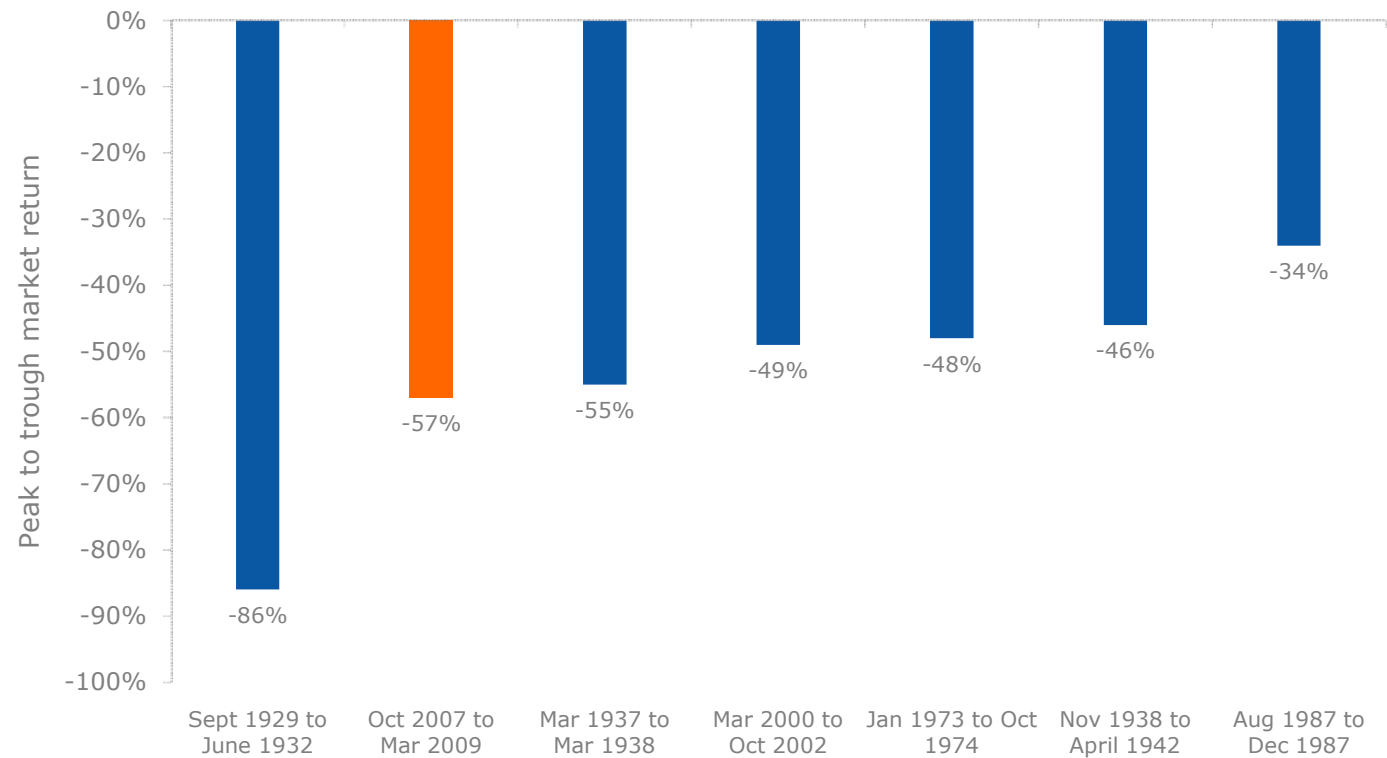
Take the \$50 loss  or flip the coin

Source: Aspects of Investor Psychology Beliefs, preferences, and biases investment advisors should know about, Daniel Kahneman Princeton University, Mark W. Riepe Charles Schwab and Co. Inc Journal Of Portfolio Management, Vol. 24 No. 4 Summer 1998

# 2007-2009 Financial Crisis

## The Great Recession

The 2007-09 bear market in U.S. stocks was the second-most severe since 1929.

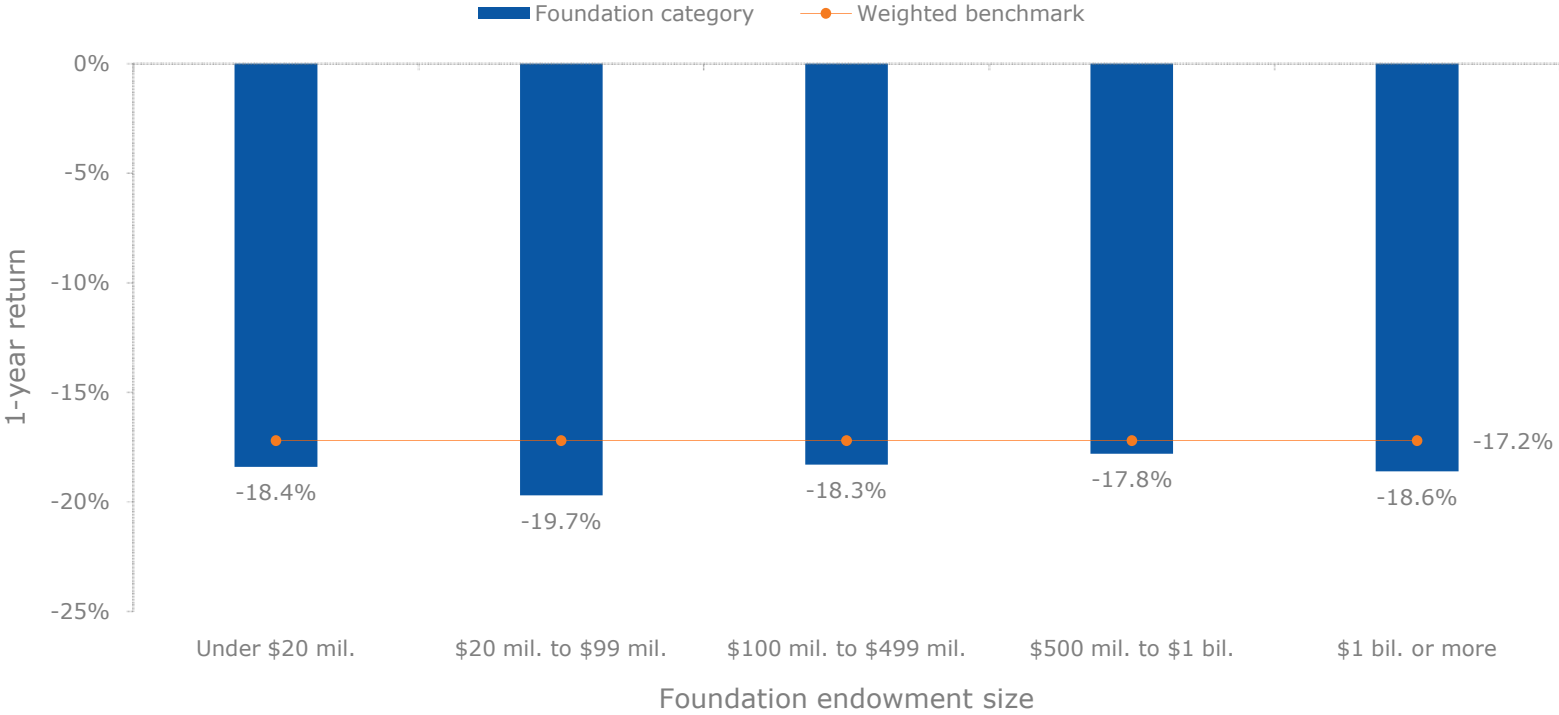


Source: Cambridge Associates.

# Impact on Foundation Investment Returns

## Large and small felt the pinch

In 2008-09, the endowments of very large foundations uncharacteristically did not outperform those of small foundations.

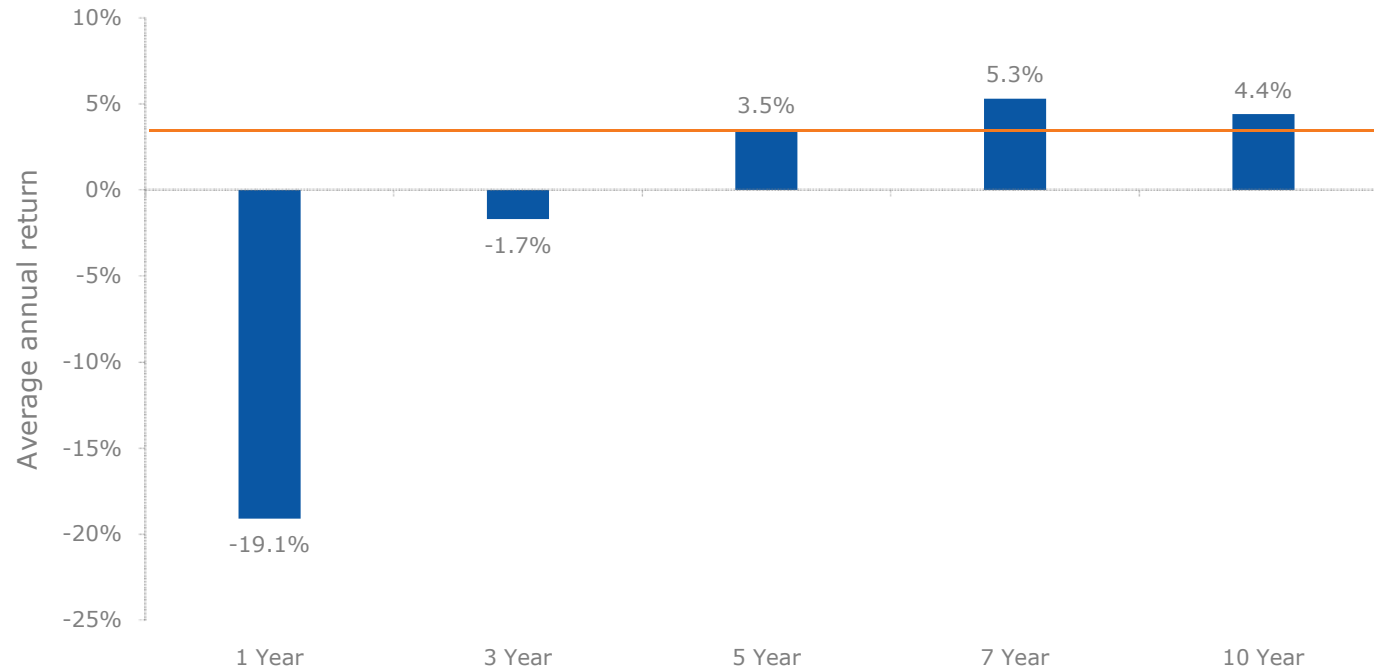


Returns are for the year ending June 30, 2009, for 22 foundations  
 Source: Cambridge Associates.

# Impact on Giving

## Tough environment to meet charitable needs

In the July 1, 2008 to June 30, 2009 fiscal year, university and foundation endowments suffered severely negative returns, pulling down their long-term average annual returns to levels insufficient to cover both inflation and the payouts required of foundations.

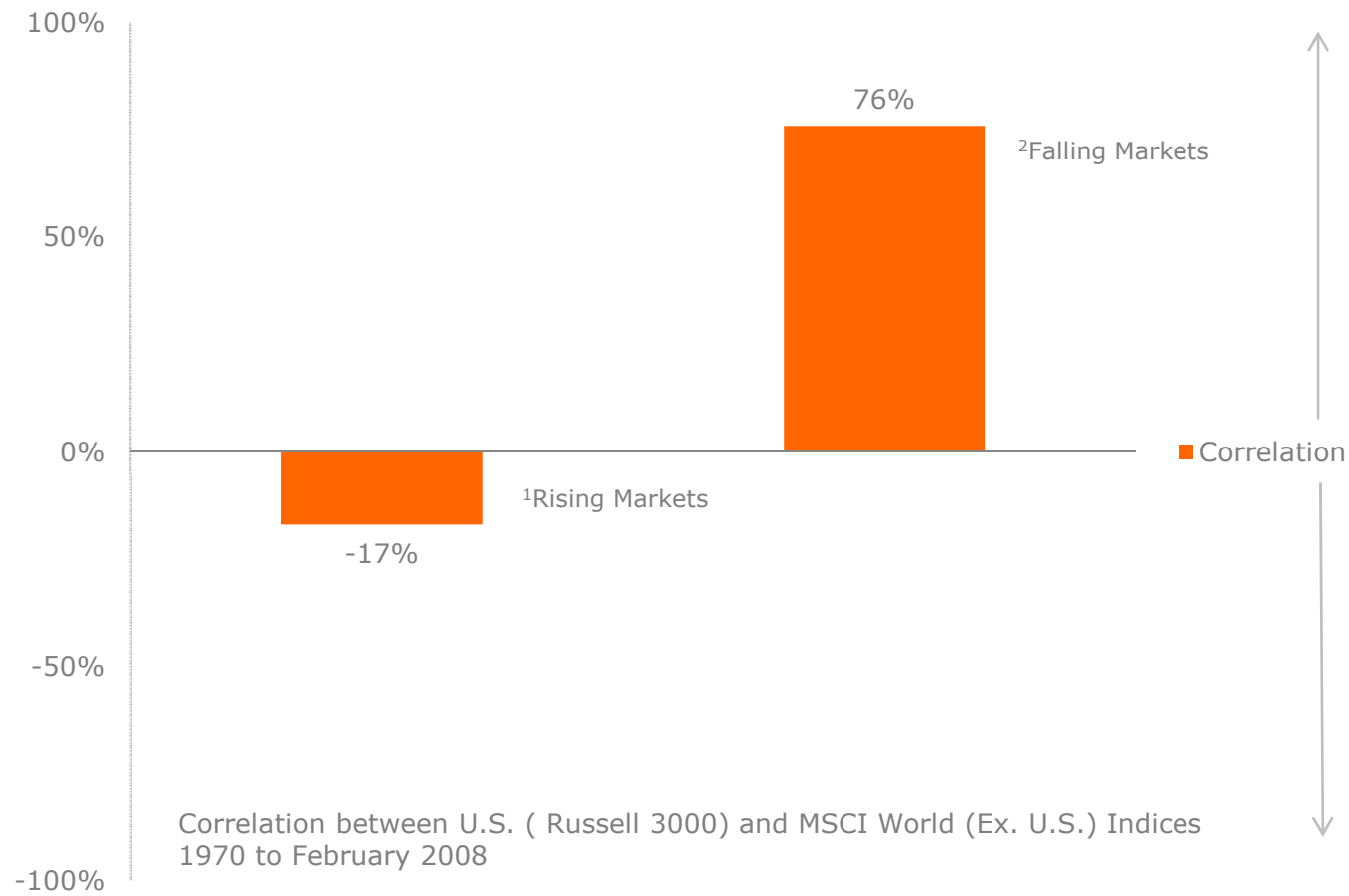


Average annual returns for 420 university and foundation endowments, periods ending 6-30-09

Source: Cambridge Associates.

# Compounding the Woes of Falling Equities

## Diversification disappears when you need it most



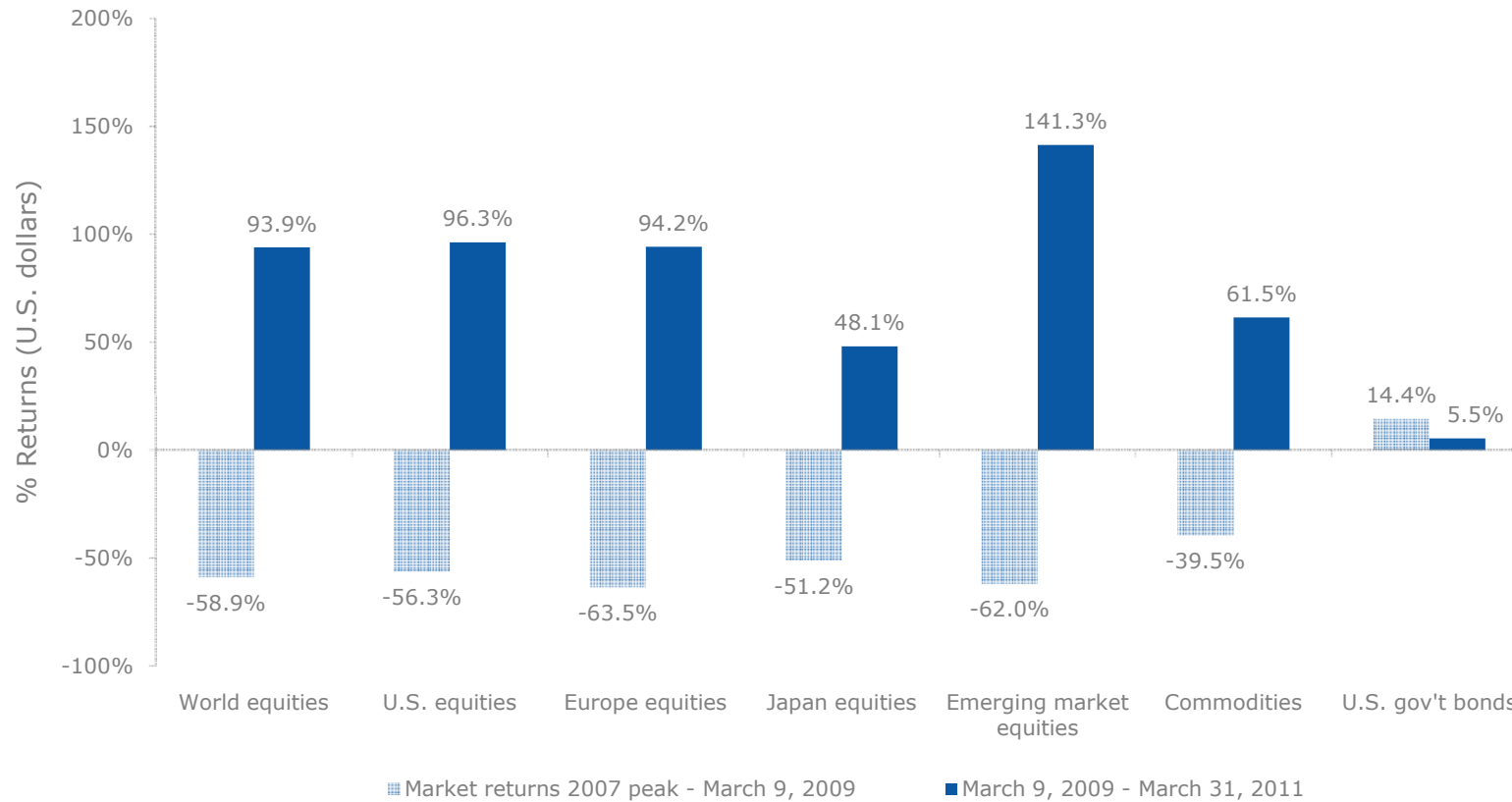
<sup>1</sup>Rising markets = returns for both markets > 1 standard deviation above long-term averages

<sup>2</sup>Falling market = returns for both markets > 1 standard deviation below long-term averages

# Crisis and Recovery

## Breathing a sigh of relief

The post-crash recovery, will it last?



Source: Cambridge Associates, Bloomberg (MSCI, Citigroup, S&P)

# Spending Policy and Asset Mix

## Searching for returns

- > Spending minimum 3.5% + administration fees
  - > Inflation rates 2.0%
  - > Foundations need investment returns > 6.0%
  - > Bond yields ( 10 year Governments) 3.25%

*This implies a significant allocation to asset classes that offer long-term risk premiums over fixed income*

# Investment Return Expectations

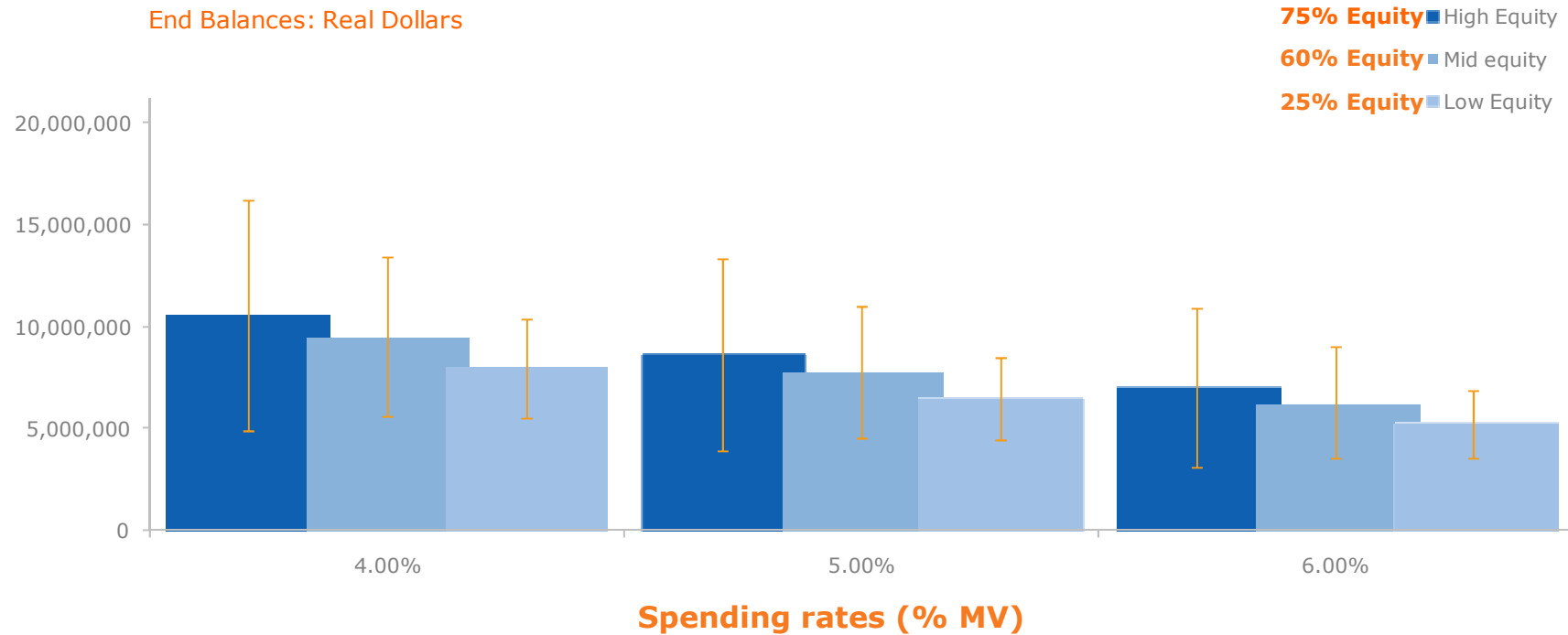
Two years into a bull market – Where do we go from here?

- > Long-term equity returns =
  - > Today's dividend yield
  - > expected earnings/dividend growth
  - > expected change in valuations
  
- > Where do these stand today?
  - > Dividend yield 2%
  - > Dividend growth 3.5% ~ 5.5%
  - > Change in stock valuations ~ stable at best
  - > Long-term expected equity returns = 5.5% ~ 7.5%

*Higher than current bond yields (3.25%), higher than equity returns over the past three years (0% from global equities (C\$), and 4% from Canadian equities), lower than equity returns over the past 40 years (10%)*

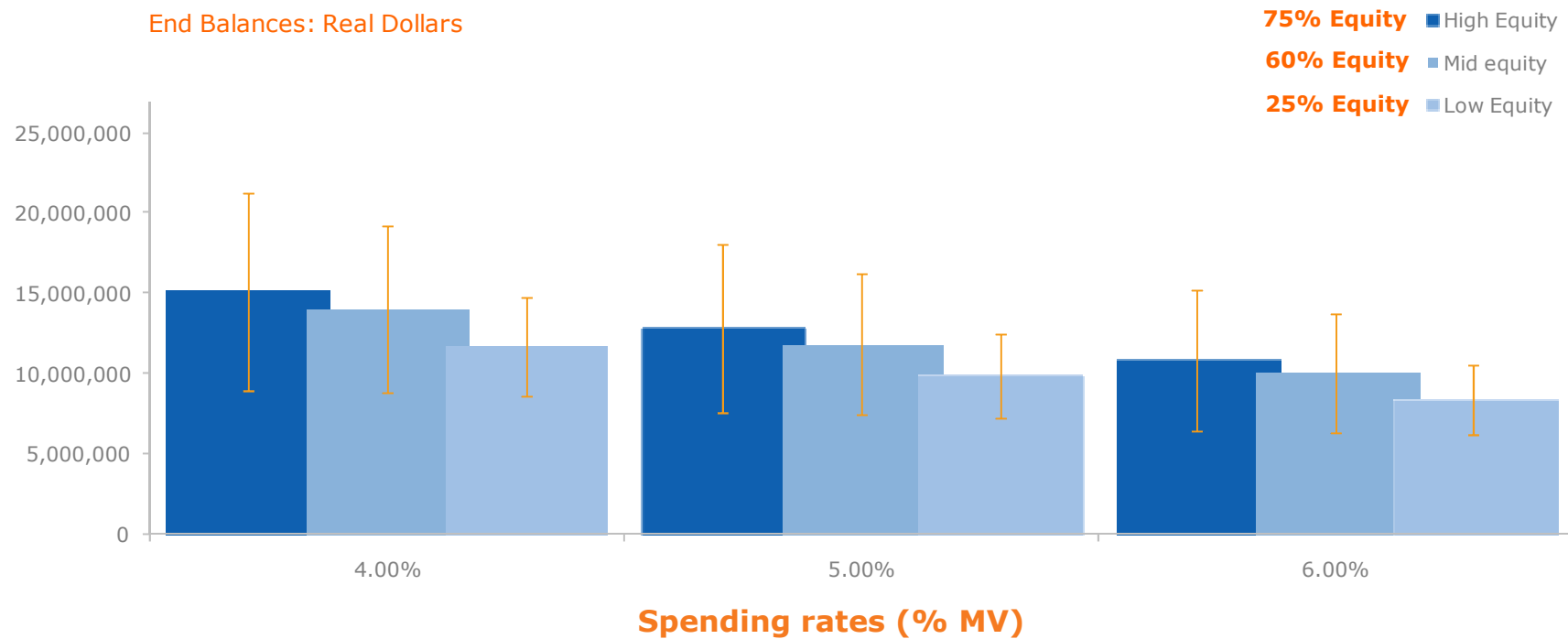
# Analyzing Spending and Asset Mix

## Scenario Analysis



Starting portfolio value: \$10MM  
No contributions

# Analyzing Spending and Asset Mix Scenario Analysis



Starting portfolio value: \$10MM  
Contributions: \$100K/yr growing at 1% p.a.

# Investment Committee

## Getting the best resources in place

- > Solo investment committee
  - > Small to mid-sized foundations
  - > Delegation of portfolio management to external investment managers
  - > Extensive consultation with investment manager on investment policy
  - > No internal investment staff or outside investment consultants
  
- > Investment Committee/Consultants
  - > Mid-sized to large foundations
  - > Increased complexity in the investment structure
  - > Investment consultant guidance on asset class, manager selection & structure
  
- > Internal (CIO)
  - > Mega-foundations
  - > High complexity in the investment structure
  - > Scale provides resources for internal investment staff
  - > External and internal investment managers

***Investment structure should be consistent with the management model that is most attainable***

# Reaching for Higher Returns and Diversification

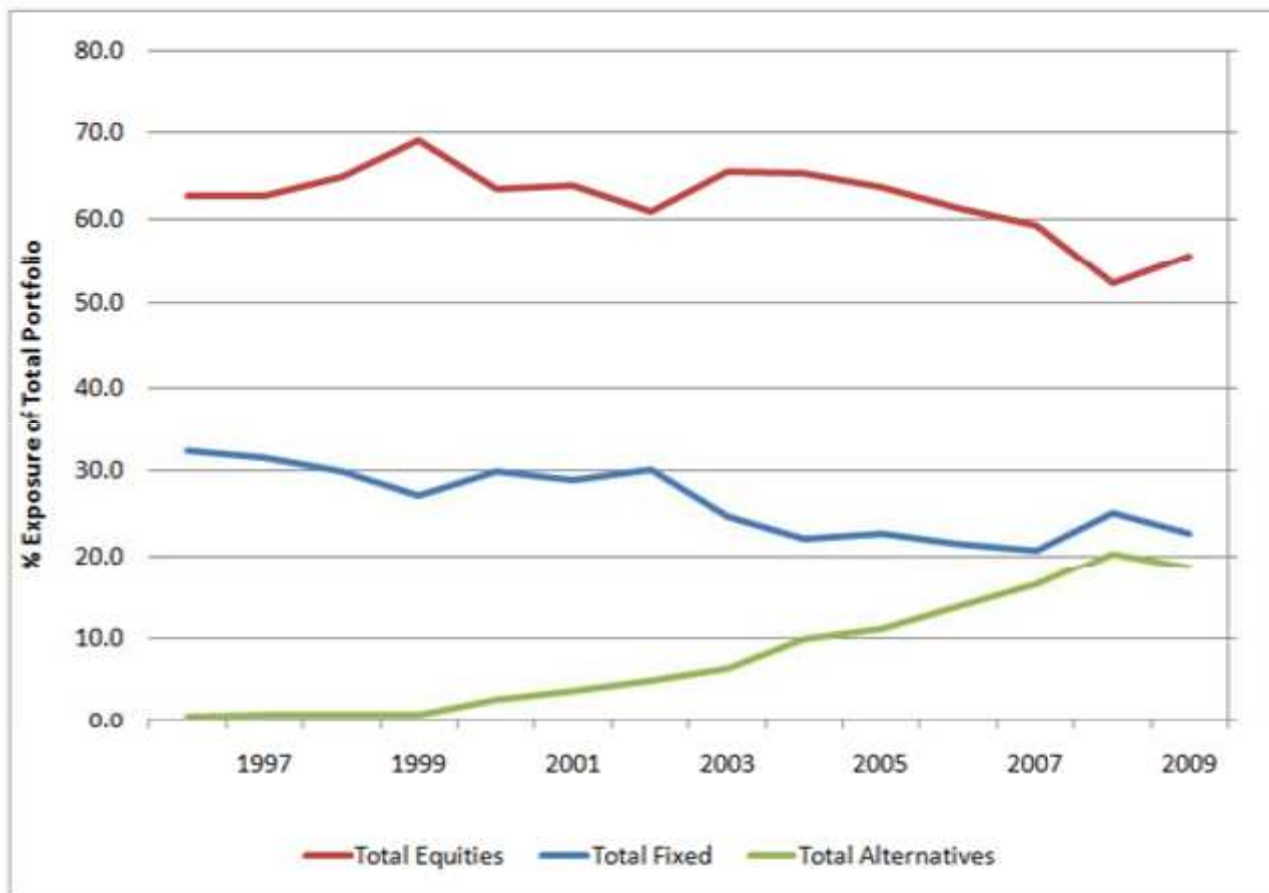
## The Holy Grail of Investing

- > Equity return potential low and diversification illusive
  - > Search for asset classes that offer equity-like returns but are uncorrelated to traditional equity markets ( The Holy Grail)
  - > Hire skilled managers within these “nirvana” asset classes



# Asset Allocation Trends

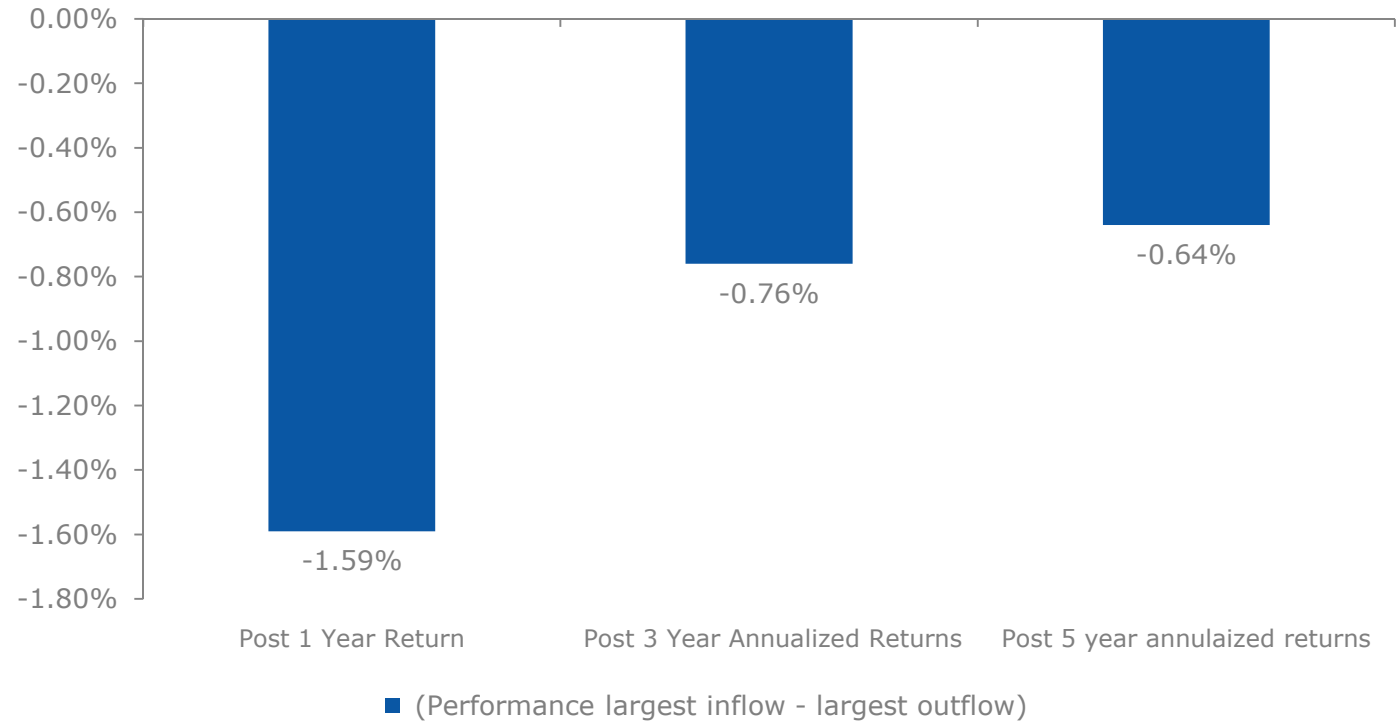
Away from traditional asset classes



# Asset Class Selection

## Return chasing?

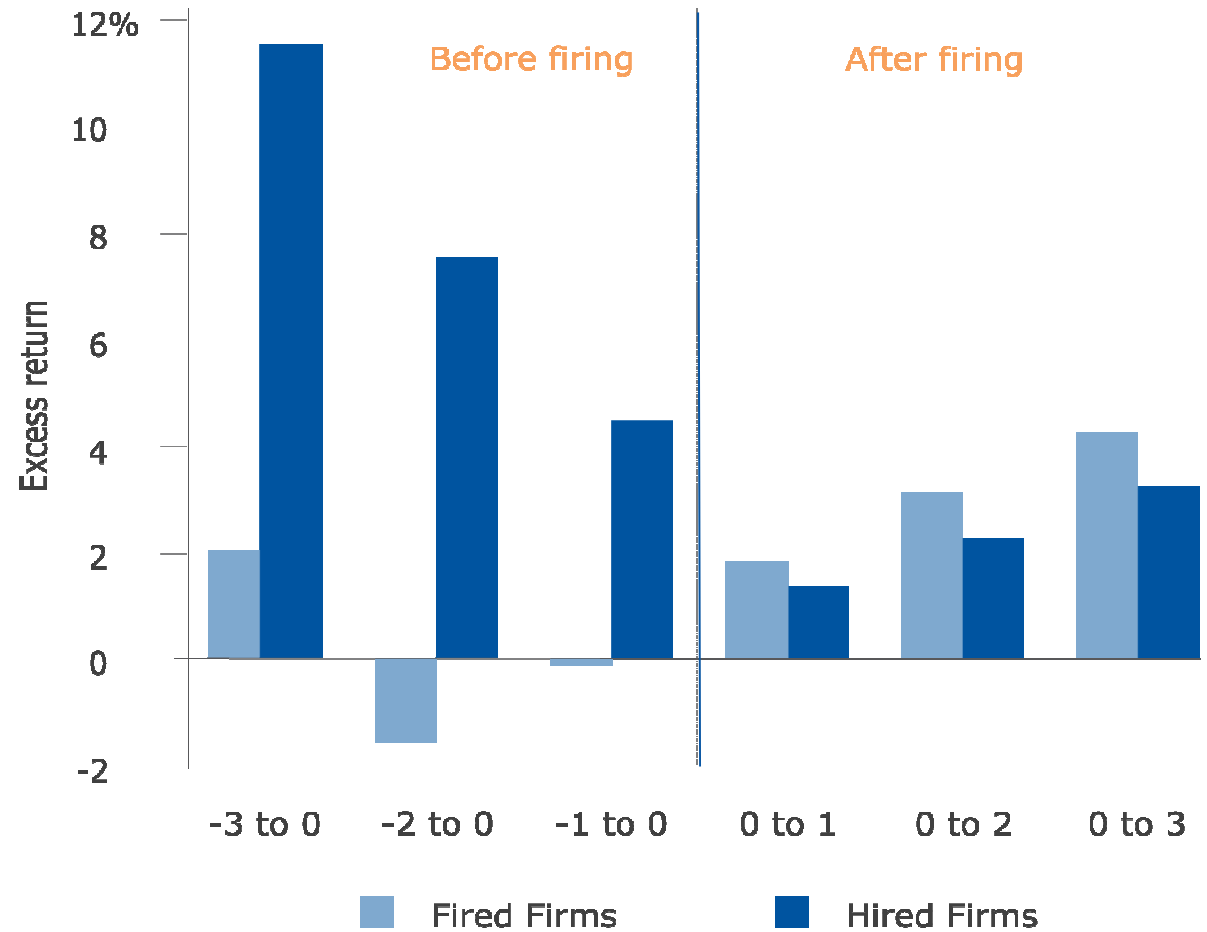
Asset Class Selection: Comparing Performance of Categories with Large Inflows vs. Outflows



Source: Stewart, Newmann, Knittel, and Heisler ( 2009) " Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors" Financial Analysts Journal, Nov/Dec 2009

# Investment Managers

## Hiring and Firing Practices



Source: Goyal and Wahal (2008).

# Investment Managers

## Selection Risk

- > Range of manager returns around that of the median manager after excluding the best and worst 5% over the ten-year period ending June 30, 2002

### Manager Style

|                                     |      |      |
|-------------------------------------|------|------|
| Large cap long only equity managers | -3%  | +3%  |
| Long/short equities                 | -32% | +32% |
| Merger arbitrage                    | -21% | +11% |
| Short Selling                       | -28% | +8%  |
| Relative value                      | -11% | +11% |
| Distressed securities               | -10% | +12% |
| Opportunistic                       | -20% | +42% |

For segments with significant variability around the median, choosing the wrong manager can be very detrimental to your portfolio

Source: Charles Schwab and Co. & Mobius M-Search

# Asset Classes

Bonds – There are risk-reduction benefits

| Sampling of Returns                    | 2008    |
|--|---------|
| 20 - 30 Year Treasury STRIPS           | 56.5%   |
| Barclays Capital US Aggregate          | 5.2%    |
| 1-Year Treasury Bills                  | 3.3%    |
| HFRI Composite Fund of Funds Index     | (20.7)% |
| HFRX Global Hedge Fund Index           | (23.3)% |
| S&P 500                                | (37.0)% |
| MSCI EAFE                              | (43.1)% |
| S&P GSCI                               | (46.5)% |
| MSCI Asia Pacific ex Japan             | (50.0)% |
| MSCI Emerging Markets                  | (54.5)% |
| HFRX Convertible Fixed Arbitrage Index | (58.4)% |

Source: Research Affiliates

# Foundation & Endowment Management

Knowing what we control and acting on it

- > Get the right structure and people involved
  - > Align investment structure with endowment model
- > Having a plan to avoid unhappy outcomes
  - > Scenario analysis
  - > Realistic asset mix and spending policies
- > Asset class and investment manager selection
  - > Awareness of decision-making biases
  - > Need to analyze:
    - > People, organization, investment philosophy and process

*Increasing probabilities for long-term success*