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Evolving Strategies of Higher Education Endowments

Higher education institutions have long relied on endowments to fund scholarships, research initiatives, and other critical programs. In recent years, however, investment strategies for higher education endowments have undergone significant changes as institutions adapt to the market and economy and seek to align their investments with broader social and environmental goals.

Perhaps not surprisingly, the most significant trends in endowment management relate to fundraising, asset allocation, and spending. Specifically, endowment managers are showing increased interest in unrestricted gifts, alternative investments, the repositioning of fixed income portfolios, and conditional spending policies that account for inflation or market volatility. At the same time, endowment committees are grappling with questions related to environmental, social, and governance (ESG) investing and diversity, equity, and inclusion (DEI).

Although there are broad differences in strategy and tactics between smaller and larger endowments, as investment committees and institution leaders consider the best ways to move forward, it can be helpful to understand national trends in endowment management and the reasoning behind them. Tapping into peer thought processes can help endowment managers make more informed financial decisions.

Fundraising via Donor Education

In 2022, as pandemic concerns waned, many organizations returned to in-person fundraising events and increased their donor education efforts. This uptick in education efforts may be a response to market volatility and the financial challenges it has created or may be a sign that endowments are entering a new phase of donor relations.

Donors are no longer seen as one-time supporters but as active and engaged advocates for the institution. As CAPTRUST Principal and Financial Advisor Elliot Greenberg explains, "Maybe more than ever before, endowments and their donors are working together as partners for the long-term benefit of the organization."

Endowment teams have gotten smarter about understanding what is attractive to donors, then teaching them the most efficient ways to donate for mutual benefit. Greenberg says, "Many endowments are actively reaching out to donors to say, 'Your assets have appreciated, and that may cause a tax burden for you. If you're philanthropically inclined, here are a few ways you might be able to lessen your tax burden and help our organization at the same time.'" Some endowments are even giving step-by-step instructions to help donors decide whether to donate cash vs. stock or donate at regular intervals vs. giving one big gift.

Endowments have also gotten better at explaining why the school itself is in the best position to decide how gifts should be spent. Over time, this may lead to a corresponding increase in unrestricted gifts. When donors understand that a gift will be prudently managed—and perhaps even grow—they feel better about making unrestricted donations.

Shifting Asset Allocations

Asset allocations are also evolving as endowment managers periodically reevaluate the best ways to protect perpetuity while supporting operational needs. Two key trends are an increased interest in alternative investments and a renewed focus on fixed income. Committee members are also starting to have more conversations about international equity.

As CAPTRUST Principal and Financial Advisor Chris Krakowski says, the interest in international equity has two likely drivers. "One is that stock valuations outside of the U.S. are currently on the lower end. The other is that the value of the dollar has begun to decline, which is a tailwind for international equities," he says. Endowment managers don't seem to be shifting their asset allocations outside of U.S. equities yet, but they are watching the trend and staying attuned to predictions.

However, many are making changes when it comes to alternative investments. In recent years, the nonprofit sector has gained easier direct access to private equity and private real estate and witnessed a corresponding uptick in allocation to those areas. Even smaller organizations are now educating their teams to understand the pros and cons of these investments. Fewer endowments are using a fund-of-fund structure, which often entails an added layer of fees, and more are working to identify what's truly best in class.

"A lot of institutions lived through the pain of building up their private investment programs when public equity markets were the top-performing asset class," says Krakowski. Now, investors are seeing some rewards for that pain, especially in the last year, when private investments outperformed most publicly traded assets. For some endowments, investing in alternatives has added to diversification and lowered the volatility of returns.

Endowments of all sizes are also taking a fresh look at fixed income and considering repositioning their portfolios. Since the 2008 financial crisis, the near-zero percent interest rate on bond investments has felt more like a parking lot than a long-term strategy for many endowment managers. Now, Greenberg says, "With increased inflation, higher education institutions still aren't seeing significant real returns on their fixed income investments. But if inflation comes down, we may see fixed income get particularly interesting for endowments." In the meantime, endowment managers are initiating the conversation with financial advisors and watching to see what happens with their returns.

Spending Policy Scenarios

Another area of evolution for higher education endowments is in spending policy design. To balance short-term goals with the need for intergenerational equity, most endowments spend between 4 and 5 percent of their total assets each year. Recently, however, endowment managers have been wrestling with the impact of inflation as rising costs and market volatility erode the value of their assets. As a result, many higher education institutions are taking a fresh look at their spending policies.

One strategy that is gaining traction is the creation of conditional spending policies, some of which tie endowment spending to specific metrics, such as inflation or the Consumer Price Index. By aligning spending needs with economic indicators, a policy that accounts for economic conditions can help an endowment support its institution in times of increased need. For instance, when inflation is higher, institutions may need to increase staff and teacher salaries and scholarship amounts. With a premeditated conditional policy in hand, the school may have more flexibility to tap endowment assets to meet those needs.

At the same time, these policies can create a disconnect between spending and institutional assets. "A policy that accounts for inflation can lead endowments to increase spending while the value of their assets is down," says Krakowski. Depending on the institution's needs, goals, and vulnerabilities, that can be a benefit or a boon.

"There is no right or wrong answer to conditional spending policy design," Krakowski says. "What's key is understanding and balancing the organization's current operating needs with the traditional goal of ensuring perpetuity."

Regardless, after the challenges of the past three years, this may be a good time for organizations to reconsider or reaffirm their current spending policies. Krakowski's advice: Take the time to model different scenarios and work to understand the short- and long-term impacts of potential changes.

Navigating ESG Criteria

Another notable trend in endowment management is the rise of ESG investing. As CAPTRUST's 2022 Endowment and Foundation Survey revealed, 57 percent of endowments and foundations believe ESG investments will increase in the next five years. Only 11 percent believe the trend will recede. Yet, in 2022, only 37 percent reported currently utilizing an ESG, impact, or mission-aligned investment strategy.

The difference is likely tied to uncertainty around ESG metrics. As Greenberg explains, "Investment committees want to be sure that ESG investing does not conflict with their fiduciary responsibilities. And if it doesn't, the next question is: Does ESG stand to create equal or greater benefits than a traditional investment strategy?"

For committee members charged with ensuring perpetuity, these are good questions to ask. But answers are complex and multifaceted. ESG strategy success can be difficult to measure, and available data is often difficult to decipher. As Greenberg says, "Deciding which companies fit into an ESG strategy is sometimes easier said than done, especially considering the lack of standardized reporting. The same company may do well in terms of impact but have a poor rating when it comes to ESG."

This can cause unwanted outcomes for an endowment, as the universe of securities that an ESG strategy would be selecting from is often dependent on screenings by these rating agencies. For example, consider an oil company that is the best in the industry when it comes to DEI practices, or a waste management company that is converting its fleet to natural gas. These companies may be changing rapidly, but the oil company is still drilling for fossil fuels and the waste management company is still contributing to CO_2 emissions. Depending on the reporting outlet, each one could have a vastly different rating.

For organizations that decide to adopt an ESG strategy, it can be helpful to start by defining an intended focus area and how much flexibility the committee will accept regarding impact and improvement. Progress is easier to find than perfection.

Perhaps to narrow their focus or to avoid these screening issues, some endowments are choosing impact investing over ESG. An impact strategy focuses on making targeted improvements in select issue areas. It means seeking companies that are making a measurable societal or environmental impact alongside a financial return. Generally, these types of companies are in their early stages, focus on innovation, and are best accessed via alternative investments.

DEI Disconnect

DEI is another growing area of focus for higher education endowments. According to CAPTRUST survey data, in 2022, 68 percent of nonprofits prioritized DEI and 62 percent of nonprofit boards engaged in formal discussions about DEI practices. Among higher education endowments, DEI implementation ranges from increasing the diversity of endowment management teams to incorporating DEI considerations into investment decisions. Endowments are also paying more attention to demographic diversity among service providers. However, progress so far has been slow.

As Krakowski says, "Higher education is at the forefront of many DEI conversations. They're putting in the work and planting seeds for the future, even if those efforts aren't visible in their committees or suppliers yet." As committee and board turnover happens, Krakowski says, DEI is top of mind for many endowment managers.

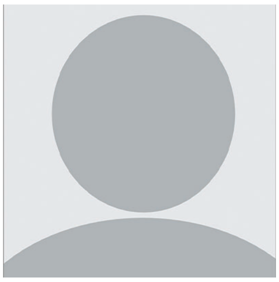
Most higher education institutions have already engaged in data-finding initiatives to establish DEI benchmarks. Greenberg and Krakowski say they're now seeing institutions expand their definition of diversity beyond demographics to include things like profession, skill set, and diversity of thought. "The idea that diverse thinking creates better outcomes also applies to portfolio management," says Krakowski. "If everyone on an investment committee is a financial professional, or everyone is an alumnus of the same institution, you are likely going to miss out on diverse perspectives."

To create diversity of thought in investment decisions, endowment committee members are starting to look outside existing networks of colleagues and alumni to recruit a wider range of board members, committee members, and service providers. They are building pipelines now to increase impact later.

But DEI is only one part of preparing for an uncertain future. As higher education endowment managers continue to balance operating expenses with short-term goals and the need for long-term stability, fundraising, spending, and asset allocation must consistently be revisited. Economic and market conditions certainly impact these discussions, as do legislation, services available from providers, and the current social and environmental landscape.

Change is constant but not usually predictable. Navigating the endless stream of adjustments and transformations in endowment management means simultaneously focusing on the present and gazing out at the long-term future. It means being informed of trends and best practices to remain prepared but still adaptable. Armed with what they learn, endowment managers can make better financial decisions and potentially create better outcomes for both the endowment and the institution it supports.

Author(s)



Roxanne Bellamy

https://www.captrust.com/people/roxanne-bellamy/