

Kara:

Hello everyone and welcome to today's webinar, Exploring CAPTRUST's 2022 Endowment and Foundation Survey Results. I would now like to introduce Heather Shanahan, Director of Endowments and Foundations at CAPTRUST. Heather.

Heather Shanahan:

Thanks, Kara. Good afternoon. Thanks so much for joining us. I'm going to start by introducing our panelists.

Chris Krakowski joined CAPTRUST in 2021. As a principal he serves endowments, foundations, corporations, and family offices. He aims to fuel growth and mitigate risks. Chris offers our clients' customized programs that are practical, research-grounded, and goal-oriented.

Chris joined us from Ellwood Associates, a comprehensive financial services firm, where he served as a senior consultant. In this role, Chris was responsible for the firm's asset allocation research and risk modeling. He was also a member of the Capital Markets Committee and led opportunistic manager research.

Prior to joining Ellwood, Chris worked at Allstate Investment as an Investment Analyst in the Portfolio Management Group. All in, Chris has been in the financial industry for 18 years and has worked with nonprofits his entire career. He earned Bachelor of Science degrees in both economics and finance from Marquette University.

James Stenstrom joined CAPTRUST 13 years ago and is a director leading the firm's OCIO, Outsource Chief Investment Officer practice. In that role, he helps nonprofits develop and implement strategies which meet their unique goals. James leads the Endowment Foundation Survey Development and Response Review. In addition, James is past grant committee chair and current board member of the CAPTRUST Community Foundation.

My name's Heather Shanahan and I'll be your host today for our fifth annual Endowment and Foundation Survey debrief. I serve as Director of our Endowments and Foundation Practice at CAPTRUST. I'm based in Raleigh, North Carolina. In addition to over 20 years of the financial services industry, I also have many years of nonprofit board experience and for three years prior to joining CAPTRUST, I served as the Executive Director of a local nonprofit organization here in the triangle in North Carolina. I also serve on the Grants and Financial Literacy Committees for the CAPTRUST Community Foundation. So let's go ahead and get started.

James, you've been the author and analyst of this survey since its inception. Why is the survey important? What background can you share, and how did this year go?

James Stenstrom:

Super excited to share this year's results. As Heather and Chris know and folks on our side knows, process really starts in April and goes throughout the year. And as this is our fifth survey, throughout the years it's grown, in terms of participation, grown in terms of our ability to draw out content that we think is meaningful to the non-profit marketplace. And so it's really exciting to do this yet again. It's kind of the result of 11 months worth of work.

And as it's grown, it's grown to be the largest publicly available nonprofit investment survey. So larger than a lot of names you may have heard of from other asset managers. And I think one of the things that's really unique about this is it includes organizations less than \$25 million, which a lot of other surveys don't. They tend to focus on larger groups. And we know just in terms of the industry, there are more nonprofits with less than \$25 million than any other segment of the marketplace.

And then the NACUBO study is out there, which is great, but that focuses on higher endowments. That's a little bit like looking at individual investor surveys and saying, "Hey, everyone over 85 invests like this. This is how individual investors allocate." So it's really diverse in terms of the number of respondents, the types of respondents. And one of the things that we really focus on throughout the survey process is really trying to get good qualified responses.

So we're not trying to run up the score count in terms of the number of participants, but one of the things that we do at the beginning of the survey we've learned, we've gotten better, is that we ask folks who are responding, what are you familiar with? Are you familiar with the investment program? Are you familiar with fundraising? Are you familiar with board governance? And only ask them questions about that. So we feel really good about the data and the content that we're able to bring to everyone today.

Heather Shanahan:

Thank you. Our next slide really gives a little bit more of a deeper dive into the demographics of our respondents. Anything jump out at you here?

James Stenstrom:

So like I said, it runs the spectrum, private, public organizations with program activities, grant making, scholarship organizations, and we'll go through some of the cross tabs which really highlight how these organizations really potentially differ from each other, so that when you're thinking about your organization and what are your peers doing, it might not be that headline number. We're able to dig into the data and provide some additional insights to really give it a much better sense of based on different types of information who peers are.

Heather Shanahan:

Great. The survey covers a lot of information. We don't have time to get to all of it today, so that's the good thing about sending out the follow-up. But let's go ahead and take our first topic and take a look at asset allocation trends. What are we seeing maybe different from 2021 as we moved into 2022?

James Stenstrom:

Yeah. So on this page and the next page, we see a pretty similar trend in terms of asset allocation shifting. We see movement away from domestic equity. We see movement away from cash. In this slide we see a little bit of movement in terms of towards international equity last year. And really you see alternatives increasing. Last year, the median investor, non-profit investor wasn't using alternatives. This year we see that the median investor is. And then as we go to the next page, we see further evidence of alternatives being something that's on the forefront of investors' mind.

So on the next page we see not only are alternatives the asset class where the most organizations are looking to make a change, so 18% of organizations. But where organizations are looking to make a change, we see a disproportionate amount, four and a half times-to-one organizations looking to add alternatives as opposed to take that away.

So I think part of that is probably a little bit of a reaction to last year where we had the S&P and Barclays aggregate bond index both down, I think for the third time in the past hundred years. So a tremendous kind of a hundred-year storm in terms of defensive assets or traditionally defensive assets like fixed income not providing capital preservation.

But I think as we go through this and we share some experiences, I think it's also a recognition of regardless of the short term, what happened over the past year, there's a lot of reasons to consider alternatives as part of an investment portfolio.

Heather Shanahan:

Chris, you're talking to nonprofits all year long. What kinds of conversations did you hear over the past year? Were there shifts? Did this come up in discussion?

Chris Krakowski:

Yeah, thanks Heather. There certainly have been shifts. I think what we saw last year as James sort of alluded to is alternatives working. And that's something that we're paying attention to. Alternatives have worked well, but in the face of rising equity markets and rising fixed income markets in 2020 and 2021, you saw those asset classes tend to lag a little bit. Complete opposite in 2022 where we saw alternatives really starting to work well.

One other thing that I'll note that you're starting to see is that, as James mentioned on one of the prior slides, or as you at least saw, non-US equities starting to get a little bit more attention from investors, valuations out there looking perhaps a little bit less expensive than the US combined with a declining dollar. And you've seen a little bit more attention that's starting to be paid to non-US investments.

Heather Shanahan:

Thanks. Let's take a look at the next slide, slide nine. There we go. I think one of the things that grabbed me was probably the footnote on this. James, do you want to speak to that for a second?

James Stenstrom:

Yes, I'm on mute again. I haven't learned my lesson. So what we see is, like Chris mentioned, alternatives have been working. And so organizations with larger asset pools, so over \$100 million you can see allocate to alternatives much more frequently than smaller organizations. And when we peel back the data, some other compounding factors in terms of general asset management fees tend to be a little bit lower for larger organizations. But far and away the biggest driver is that those organizations are using alternatives and using alternatives more, using more illiquid as opposed to liquid alternatives.

I think if you just go back to, I hate to do this, go back to the previous page, it has one of my favorite stats of the whole survey on it related to alternatives. So we have why people use it, increase portfolio performance 64% and why people don't use it. So typical reasons that I'm sure Chris runs across when he's having conversations, liquidity, complexity, cost, but that 10% no perceived benefit I think is incredibly interesting. If organizations who aren't invested in alternatives, there's reasons why they're not invested in alternatives, but only one in 10 of those investors thinks that there's no benefit.

And so a lot of what Chris does, a lot of what we do on our team is investors make the right decision for them by and large with the right education, but it's making sure that we provide the right education, we provide diverse ideas in terms of how to allocate to things beyond traditional equities and fixed income. Because if you look at the numbers, organizations who invest in alternatives tend to have better returns. And even organizations who don't, most of them think there's a benefit.

That's one of my favorite stats from the whole survey. But you can go back to the previous page. That took us a little off target with that one. But yeah, as you can see, larger organizations, organizations that allocate more to alternatives, there is a financial difference in terms of outcomes.

Heather Shanahan:

So Chris, on slide 10, I mean I think we hear diversity is the goal, liquidity is the concern, especially with smaller organizations that may have a finance committee, not an investment committee, or they may have an investment committee that's just not savvy either that's just what happened or through attrition. How are these conversations going? What are you doing from an education standpoint? What do you think is important for folks to know?

Chris Krakowski:

Yeah, I think and tying into James's comments, not only are larger institutions the ones that tend to use more alternatives, but as you can see on page 10, particularly on the bottom left-hand side, larger organizations tend to use less liquid alternatives. If you look at the broad survey in that kind of line at the top there, you can see that it's pretty evenly split in terms of liquidity across the base of participants in the survey with about a third using mostly liquid alternatives, a third using some combination, and then a third using mostly illiquid alternatives.

But as you look to that chart on the bottom left, again, it's the larger institutions that tend to use more of the illiquid investments. I think there's a few reasons for this. Liquid alternatives are an easy way when you have, again, the liquid, easily traded, alternative investments, they're a quick and easy way to add diversification to a portfolio, potentially increase expected returns, and at the very least, hopefully decrease portfolio volatility a little bit.

But they do tend to have a little bit lower expected returns, we would say, than the true illiquid investments. That said, I mean illiquid are complicated. Like I said, you tend to get higher returns and they do increase diversification. They do tend to reduce volatility. We really did see that last year with the private equity and real estate and private credit investments tending to hold up a little bit better when public markets were down. So those are the positives I'd say to the illiquid side of the equation.

But on the other hand, there are some challenges that I think a lot of organizations have to get past. They're administratively complex. When you look at the illiquid private equity or private real estate funds, they're costly. And probably one of the more important things is that they tend to have a performance drag in the beginning. So as you start building up an illiquid program, you go through what's called the J curve where you tend to sustain either losses or very low returns in the beginning, and then the returns come a little bit later in the fund life. So you really have to be patient and be willing to push through that area when you're adding to illiquid investments.

Just to finish off on that, I'd say we do a lot of detailed education to try to make nonprofits aware of the pros and cons to illiquid investing. Where they tend to be really successful is again, the knowledge and ability to tolerate those J curve investments. When you have staff available to assist with things like subscription documents and ongoing requests and the right custody bank, a custodian is going to be key in managing the capital calls and distributions associated with those illiquid programs.

So I think that's part of the reason why you tend to see them more utilized in the larger endowments and foundations. And frankly, there are times when they're not successful, and that's if you start a program but you don't continue it, that can create the administrative challenges without the corresponding benefits. You don't want to underestimate your liquidity needs and end up in a situation where you have illiquid investments but tend to need liquidity, and just ensuring that you maintain enough dry powder to meet those capital calls.

So I'd say it's a really complex conversation. It requires a lot of education. And some clients, some nonprofits tend to go in that direction and some review the education and decide to stay in the liquid portion of the alternative space.

Heather Shanahan:

That's a good summary. How about slide 11? This kind of summarizes to wrap everything up, James. Is there anything you would add additionally to this conversation?

James Stenstrom:

I'm terrible at this. Chris said a lot of the important points. One of the questions we asked is why investors allocate to these different types of alternatives. And something that we were expecting to see going in is that perhaps the goals were different.

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James Stenstrom:

... see going in is that perhaps the goals were different between illiquid investments and liquid investments. As Chris mentioned, illiquid investments tend to have a little bit higher return profile. Liquid investments tend to have a little bit lower return profile and generally why investors say alternatives, yes, illiquid alternatives, no. It's for diversification purposes as opposed more to increasing portfolio performance. We see that a little bit in the data. But by and large, the rationale is really kind of viewed as the same. And so that's somewhere where we were expecting to see a split.

And then the other thing that we can see in terms of year-over-year changes is that private equity supplanting private real estate is the most popular illiquid alternative asset class. And so certainly some concerns for anyone who reads, I was going to say the Wall Street Journal, but any newspaper in terms of real estate in the coming year and what's happened with rising interest rates. So not a total surprise there, but certainly something that's interesting and noteworthy.

Heather Shanahan:

Okay. Let's switch gears to another topic that comes up a lot. Sometimes there's action taken, sometimes there's not. We'll talk about that too. So on our next slide, ESG impact and mission aligned investing not all being the same thing, so it's probably important to give a little clarification on that, define some terms.

So ESG stands for environmental, social, governance. And it's a strategy that aims to mitigate risk while aligning fund decisions with an investor's objectives and ethical motivations. The goal is to also bring a level of transparency that makes it easier for investors to conduct peer fund assessments.

ESG takes a look at companies and assesses their environmental impact on the E. So whether or not they're good stewards of the environment. Are they creating excessive waste, or waste, that's a hot topic right now. Do they waste energy? Do they treat animals well? Those are the types of concerns that fall into the E category.

Social impacts, how do they treat their employees, their community partners, their customers, the companies that they interact with? And finally, governance. How's the company led? Do they have good internal controls and do they respect to listen to their shareholders? So those are the kind of three things that broadly ESG covers.

Then there's SRI or Mission Aligned Investing. So, simply put, it's choosing to invest in companies and funds that have positive social impacts. Strategies might include things such as not investing in companies that sell or support things such as alcohol, tobacco, gambling, and instead choosing to align with companies that support causes such as racial or social justice, environmental sustainability or clean

energy. Ideally, both financial gain and social impact are achieved. And overall, SRI focuses on the avoidance of harm.

Then there's impact investing. This is a broader term that may include ESG and SRI and/or SRI. Again, investors who use this strategy are considering a company's commitment to corporate social responsibility. While the bulk of impact investing is done by institutional investors, there are options for individual investors as well. Impact investing also suggests positive impact through investments and may include more local, more specialized investment such as microfinance. Impact investing seeks investments to optimize goals other than profits. It's nice when it all works out. That's what we do as well. But that's kind of our overall goal there.

So, Chris, we see questions come up a lot in RFPs for sure. It's a hot topic for many organizations and boards, but where do you think we are on this and who's really driving the conversation at this point?

Chris Krakowski:

So it's been a hot topic certainly for the last few years, if not longer, Heather. What's interesting, I think is the data on that line chart on the left-hand side. You've seen, going back a few years, that the percentage of nonprofits utilizing ESG or some type of socially responsible investing in this case has been increasing, I'd say until this year. And it looks like it's sort of plateaued as we went from 2021 to 2022.

There's probably a lot of reasons behind this, but one might be that the knowledge gap has shrunk in ESG investing. I think there was a lot of interest in institutions learning more about ESG, trying to determine if it made sense for them. And those that really wanted to pursue ESG investing have likely given it a lot of thought or actually started on it. And those that didn't have gone through the education process and moved on to the next thing.

So I think we are starting to see a little bit of a plateau, at least in terms of the results of this survey. And there's probably a couple other issues out there that nonprofits are dealing with in terms of ESG. Some have had discussions and they have interest in actually pursuing it, but they're waiting.

One thing that's still kind of lacking in the industry is standardized reporting for ESG and really trying to determine ways to measure the impact you're having. I think it was easy when you go back to 2020 and 2021, ESG investments were outperforming broad markets. And so you could say we're doing good and we're adding value relative to a benchmark. That changed in 2022, as the best performing asset class within equities was energy.

And so that tends to not make its way into a lot of ESG portfolios. And so ESG underperformed last year. So another potential reason why we're starting to see that plateau a little bit. But I do think you've got a combination right now of those that wanted to get in have and those that do maybe are still waiting to materialize some good reporting standards or something to that effect.

One other thing I'd add too is there are nonprofits that I work with that have an interest in it and have started what I'll call maybe a really small learning portfolio where they're taking a small allocation, not overly meaningful, but a small allocation, testing out some different strategies and trying to determine how it works for their portfolio and maybe waiting until you get more standardized reporting before they ramp up that program.

Heather Shanahan:

I think waiting seems to be pretty prevalent. I think we saw that a lot over the last year of conversations with boards and yeah, we want to talk about it and then you talk about it and they all go, hmm. Nobody's quite ready to take action there. So unless it's a really clearly defined mission like

environmental, pretty straightforward, but some of these others, it's kind of hard to actualize, this is our mission, so what does that mean in terms of our investment decisions?

Let's take a look at slide 14. And James, this gives us a little bit more information about who's adopting and then who's not adopting on 14 and 15 talks about who's not.

James Stenstrom:

Yeah, so this gives us a sense of who's adopting, like Heather said, and where that's happening and the prevalence in terms of which asset classes you're seeing, all or mostly aligned and which asset classes you're seeing more conventional. So alternatives, high on the conventional and then more traditional asset classes a little bit spread all over.

And I think, like Chris and Heather said, ESG mission impact, they're similar, but they're also very different. So ESG, a lot of times you'll see implementation taking the form of something that's off the shelf and I want to incorporate these values and they're positive. And it's really, really hard for an organization, which is individuals, at the end of the day, a board to look at and say, "Well, what values do we want to have in our value? And how do we want to weight the relative value of avoiding child labor versus responsible environmental practices?" That's a really hard decision.

And so what you see is a lot more standardization in going out and buying investment products, which try and incorporate and have investment in businesses that have our leaders in corporate responsibility and sustainability. And then socially responsible or mission aligned strategies, a lot of times those are trying to avoid companies with business practices antithetical to your values. And so that's more screening things out. And oftentimes that's more of a customized strategy.

If I'm a zoo or if I'm whatever type of other organization, like I may have things like animal welfare, if you're a zoo or SPCA, it might be a very clear mission alignment. And so that's really where we see the commonality between these three different strategies that have slightly different meanings and slightly different terminology is by and large, it's aligning values with the investment portfolio.

And so we see mission related investments coming up as the highest response. And I think there's a little bit of potentially response bias with this is, I think that that's probably higher than what a textbook definition may say is the most prevalent investment strategy. But I think what that's highlighting is that organization's view, who have gotten to the point of implementation. Because this is all people who have implemented. And they've gotten to the point of implementation, that's how they think about their investment portfolio, not necessarily as environmental or social or DEI or sustainability. They may think of it as related to their mission.

Heather Shanahan:

The next slide, the folks that are choosing not to.

James Stenstrom:

Yeah, and so in terms of folks who are choosing not to, Chris hit the nail on the head, which is, ESG did not perform particularly well last year. Energy was a leading sector. And so previous years, we looked at enhanced returns, neutral or detract from returns. Enhanced returns and neutral work, top two responses. Detract from returns is the least popular.

This year, energy outperformed. ESG strategies by and large outperformed over a one-year basis, but the tack from returns went from last to the top concern. And so if you look at organizations that aren't investing, performance impact is by far and away the largest reason, our opinion. And then ability to track specific impact.

I think that kind of highlights what Heather and Chris were talking about a few minutes ago was when it's outperforming and everything's going up, everyone's happy. When it's underperforming, you've really got to have conviction in terms of what is the impact I'm making with this investment? And do I have conviction to stay with that program? Or hey, when things aren't going well, I don't have conviction. When somebody asks me why are we doing this or what impact is it making, I don't really have data to point to. And I think that those two things are actually pretty related in terms of inability to track specific impact and the potential performance impact.

Heather Shanahan:

Chris, would you add to that? Are you seeing local impact investing as being something organizations are turning to or is it really more of a portfolio decision?

Chris Krakowski:

To some degree, yes. But I'd say that some of that impact investing occurs outside of an investment portfolio. When you think about really local, mission-driven investing, that tends to occur outside the purview of the investment portfolio. There's certainly impact investing that's going on, whether you're targeting a specific environmental or social or specific category, and you kind of go from ESG, which is a little bit more broad to a targeted impact strategy within your investment portfolio.

We've certainly seen a significant amount of that, I'd say across nonprofits who do utilize some sort of socially responsible investing. But the local mission related investing tends to occur more at the organizational level, I'd say, than the investment level, at least in my experience.

Heather Shanahan:

That makes sense. I think slide sixteen's very interesting and I think this kind of speaks to some of the things that we've been talking about. I participated in a board meeting last week, and the organization's very focused on social and racial justice and they were looking at their historical portfolio and they owned a lot of beer stocks and I can't remember, one of the big growers that will remain unnamed that invests in GMO research.

And there's a lot of conversation about, well, we've not... And they've just started to take a look at how things are currently structured and we're not managing the portfolio, I'll say that too. And then there's all this discussion, well, is beer bad? I don't know. And we have to feed the world. So then it's kind of, well, then you may think these things are antithetical to what you're trying to do from a mission standpoint, but somebody else may have a very different opinion. And I think this slide says it all.

So James, what will you tell us about this slide? I think this one's really interesting.

James Stenstrom:

Yeah, we could have, I think, changed the axis on the left-hand chart because it goes all the way to the right, but that's 27%. So when we ask individual participants what their highest priorities are, and we let them choose more than one, you don't have a strong consensus.

So when we started asking this question two years ago, pro environment was actually the most popular. And that's seventh this year. Last year, pro racial minority equity, that was the most popular. And this year you see anti pornography is the most popular. And so it's difficult to create consensus if you don't have a strong mission as an organization, which may map into this kind of framework. Or you may have a very strong mission as an organization, but it might not map into investment decisions or types of companies that you want to either invest in or avoid.

And then on the right-hand side of the page, this charts a little confusing, so I'll explain it quickly and as best as I can. But we ask individual participants how important ESG, mission-aligned and impact investing is to them. And then what they view their organizational.

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James Stenstrom:

... Investing is to them, and then what they view their organizational consensus as. What we see is that across the board, individuals are less concerned with doing that kind of investment than they perceive others. And so, I think what that tells us is that everyone's looking around the room and saying, "Well, I think other people care about this. I maybe care about getting this meeting over with," and you don't have a lot of people ...

You certainly do have champions in some organizations, and that's great, because I think that's what you need to get change in doing something different in the investment portfolio over the hump. But we see that that's not consistent. There's not a champion within all organizations.

And so, I think that, in addition to some of the other things that Chris mentioned, is one of the reasons that we see a plateauing or slowdown in terms of the adoption of ESG.

Heather Shanahan:

Makes sense. Just the fact that every single year, this has changed in terms of what's important. It's probably important to recognize that we work with a lot of clients in the religious services space. And so, when you think about who responds to the survey, that top category is going to be of utmost importance.

James Stenstrom:

Yeah, I think that's a really important thing to highlight in terms of differences of organizations. If you look at some religious investors, oftentimes there's the Catholic church, there's the United Methodist Church, there's this larger organization which has devoted time and resources that gives to their constituencies. These are the socially responsible rules with which you should invest by.

And so, if you're on the investment committee there, it's not the exploration of what's important to us, it's we have something and how do we implement that? So it's a very different process for religious organizations. Certainly some overlap of their values, and I think that those organizations are very important. But there's a starting point which may not be there for other types of organizations.

Heather Shanahan:

Chris, anything to add about building consensus around this discussion?

Chris Krakowski:

I mean I completely echo James's sentiment that this is probably one of the reasons why we're seeing ESG plateau is just you have so many different personal views, and you have a group of committee members or board members sitting around trying to determine how and if we're going to incorporate ESG into the portfolio, and everybody's approaching it, even those sitting on the same organization, everybody has different personal backgrounds. So just trying to get those individual opinions together to determine the organizational priorities is a challenge. I think once you get past that hump, one of the

nice things is everything on the left-hand side, all those categories are very different. But ESG can be highly customizable.

So if you can establish the organizational priorities and get past all the individual views on things, then you really can customize an ESG or impact portfolio that targets what the mission of the organization is.

Heather Shanahan:

You made a point, Chris, when we were preparing for this discussion about looking at ESG and not all things are equal, and that the G part of that discussion sometimes gets lost. So curious about your thoughts there.

Chris Krakowski:

It does. The idea of environmental, social, and governance, I think environmental, you can see it here. It makes its way into those personal views a couple of times, specific environmental focus. There's the social aspect as well. I know a lot in the survey focuses on DEI, diversity, equity, and inclusion, which can tie into that social aspect of ESG.

But governance is something, I think, most investors are hoping that their investment managers, regardless of whether or not they have an ESG focus, that they're really looking at the governance of an organization and making sure that it's top tier.

So I think the broad ESG mandates definitely incorporate that from a quantitative perspective, but you don't see as many organizations, I'd say, specifically targeting the G of the ESG investing. Now governance, when it comes to the organization, there's a lot in this survey that teases that on. I think that there are some real interesting statistics there.

Heather Shanahan:

Perfect segue. Thank you. Let's take a look at the next slide. It's our next topic. It's a hot topic this past year, I tell you. There's just been a lot of interest and feedback from nonprofits about governance and best practices and making sure that we have things in order and that our board is educated. So let's spend some time talking about some of the feedback from there.

We as an organization provided a lot of collateral over the past year about a methodical way to shift spending policies in light of current turbulence and economic conditions. It's interesting to see, did organizations do that? Were they prepared and they didn't need to? So, James, let's talk about slide 17.

James Stenstrom:

On the mute button this time. Yeah, so, as you can see, most organizations have their spending rate clumped in 4% to 5%. I think that's, given some of the statutory requirements for private foundations, something that you would expect. There are certainly some organizations with higher, some organizations with lower.

Something that I expected to see a lot more correlation on was, well, what your spending rate is, your expected return on assets should be somewhat similar. If I want to spend 7%, I want to earn 7%, or if I want to spend 7%, maybe I want to earn 5% with 2% as a long-term inflation expectation. What we saw was literally a -0.2 correlation, so almost no correlation between return expectations and spending rates.

So I think a lot of the conventional wisdom around especially private foundations, if you want to spend 5% and then 2%, 2.5% for inflation, and maybe half a percent for fees, so you want a return somewhere between 7.5% and 8% is the conventional wisdom.

I think what we see is that's not particularly true for a lot of organizations. There's a lot going on under the hood in terms of whether it's capital campaigns and fundraising or whether it's larger expenditures in terms of capital expenditures, all sorts of things going on under the hood that what you want to return and what you want to spend may not have any alignment at all.

Then I think in terms of it being a hot topic, what we see is a lot of what potentially may be driving organizations coming in under or above their spending targets is whether they're still fundraising, whether they're creating net inflows or net outflows, because we saw pretty shockingly 43% of organizations that are experiencing net outflows spent above their spending plan, above their spending policy. There's only 7% of organizations that are creating net inflows are doing the same.

So I think it's especially something for organizations who may be in a spend-down phase to be really cognizant of that, because that's something which can happen. I think there are some governance techniques which can help organizations really align their spending and their actual spending in the policy.

Heather Shanahan:

Let's take a look at slide 18. Chris, this is something that you spent time reassessing over this past year. This shows no change for a lot of organizations, but does this come up in conversation?

Chris Krakowski:

It has. It's not new to be having spending conversations, but the dynamics of those conversations have changed a little bit. So as we look back a few years ago, I think even though the survey results indicated that there wasn't a strong correlation between returns and spending, there were still some questions about whether spending rates were sustainable. Fixed income was yielding zero or close to it in many cases, equity markets felt a little rich. I'm going back a couple of years here. So I think there were concerns about forward-looking returns and the ability to meet spending.

That conversation has shifted this year, and really it's shifted to the impact of inflation. I think that there are certain institutions that are really having these conversations. I'd say I mean it impacts every organization, but when you think about higher education institutions or organizations with a large staff, a big field presence, not-for-profits, they're dealing with higher administrative expenses, they're dealing with cost of living increases for staff, for faculty in the case of higher ed. They're seeing higher inflation in a time period when their portfolios were down. So there's this interesting disconnect between the increased need for spending and the lower portfolio values.

There are some spending formulas. I mean as we look at this page, you'll see that quantitative spending formulas are widely used. About 85% of respondents use some sort of quantitative formula. I think in many cases that's a rolling average, whether you're taking 12 months or 20 months of portfolio value and averaging those and calculating your spending there. There's a hybrid methodology in which case sometimes includes an inflation component.

But there's just a lot of questions about how to tie spending into inflation. When you do account for inflation in a spending policy, it can make sense in a time like this for organizational needs, but it does create a disconnect between the portfolio returns and the actual spending in the portfolio.

So there's certainly no right or wrong answer from a spending policy standpoint. Understanding the dynamics, every organization is different, so now is a really good time, I'd say, to talk about, to reaffirm spending policies, seeking input from the organization, as well as an advisor who can weigh in on different types of spending policies, how they're going to impact the portfolio.

But once you come up with the right spending policy for your organization, it makes sense to stick with it. Don't be reactionary in this environment. That's something we're certainly guiding nonprofits on right now, is not to be reactionary and try to change the spending policy in light of inflation or last year's returns.

Again, it's really good to just take that policy, reaffirm it. If you need to change it, great, but don't change it on an ongoing basis just to try to match what's going on in the markets.

Heather Shanahan:

[inaudible] feedback. James, anything to add on the analysis from 18 before we go to 19 on the slide?

James Stenstrom:

No, I agree with Chris. If you're changing your spending policy every year, you don't really have a policy. And so, it's an important thing to revisit periodically, but it's not something ... Your organization's going to be more sustainable if you don't vacillate between different methodologies.

Heather Shanahan:

Let's talk about seven ... Let's see, point seven. I'm like at seven because that jumps out at me. But slide 19, seven's an issue. It's something that I know that we are getting a lot of feedback on. But, James, what else jumped out at you here?

James Stenstrom:

Yeah, so across the board, we see pretty good adoption of governance best practices. I think the thing where we see less than half of organizations doing is fiduciary training. Something that when you look at the cross-tabs really jumped out at all of us was that about 60% of organizations have term limits. If you have term limits, those organizations do every one of these eight things more frequently than organizations that don't. And so, I think there are certainly views on both sides in terms of term limits. Obviously there are certain times there's political issues, certain times there's a desire for continuity. I think what the data really tells us is that having term limits can potentially make your organization more sustainable and have more continuity than not.

I think it's really a shift of mindset, depending on your age and life circumstance. If I told you in three years somebody had to raise your kid, or in three years somebody had to take care of maybe a parent of yours, you'd be a lot more diligent about making sure that there were best practices, that there was good governance, that things were recorded, that you had the policies and procedures in place for that to be done successfully. I think the same thing applies here.

And so, organizations who may be hesitant for that reason in terms of continuity or sustainability, I think the data actually bears out that you're going to have better governance practices if you incorporate term limits. You have people knowing, hey, someday I'm going to roll off and give this responsibility to a new generation, that that actually creates more sustainability.

Heather Shanahan:

Yeah. That's a painful thing, especially a smaller organization that's grown along the way, and all of a sudden they're a larger organization and they don't have some of these pieces in place. There's a nonprofit that we're working with that didn't have term limits, and implemented them sometime over the last year or two, I think.

And so, now you've got these legacy board members that have institutional knowledge, that are heavily invested, 12 years on the board, and they're in the process of making leadership changes and investment management changes, and the head of the investment committee can't vote now because ... Yeah, and he's the one that's been there the longest. And so, it's a painful shift that's not in place. Anything else, Chris, from your experience in terms of best practices, things that you're seeing and hearing?

Chris Krakowski:

I mean aside from the fiduciary training, I think that it's good to see that institutions' formal investment policy, 95% of respondents have a formal investment policy. That's really key to allow managed investment program.

So I think on this page, other than a couple of things, nothing really jumps out. It seems very consistent with a lot of well-run organizations that are participating in the survey.

Heather Shanahan:

Good deal. From a ... What does ...

PART 3 OF 4 ENDS [00:45:04]

Heather Shanahan:

... and it's from a, what does fiduciary training look like in a nonprofit space today? We're not governed by EIRSA, it's different. So I think sometimes boards struggle with, "Well, what do I make sure my board members know? What can I hold them accountable for? What do they understand?" Unless you as a board member have had the opportunity to participate in some kind of board training, sometimes you don't know. You're passionate about the mission, maybe you don't have board experience, and so there's a big learning curve. So that's a really important thing for organizations to address for sure. Let's take a look at committee structures on slide 20. I think this is interesting too. James, do you want to talk to this?

James Stenstrom:

Yeah. So as you would expect, if you look past these headline numbers, committee size, larger organizations tend to have larger committees, not a big surprise in terms of investment in finance committees, more assets, potentially more sophistication. I think that could potentially play into having the right level of expertise to execute on things like alternative strategies that we talked about earlier. As we look at member expertise, this is the breakdown of what people's roles are, what their data options are, in many cases were in terms of their professional experience. Heather and I actually did a podcast, which you can find on the website, where we dug into looking at membership, not necessarily on expertise, but also, in terms of profile, age and demographic profile. What you see with the membership composition of investment committees is that about 93% of investment committee members are either senior level career professionals or retired, which means that 7% is in that younger generation, which they're certainly pros and cons.

But then also when you look at diversity in organizations that are less, I feel like they're not meeting their standards on diversity are not where they want to be, if you just look at the statistics in terms of younger generations, if you look at college graduates across the board, non-college graduates, every generation in the country is getting more diverse. So there's potentially some opportunity to bring unique perspectives, not only in terms of generational differences, but also, I think what many

organizations will find is that just naturally bringing younger generations will help with potentially diversity along the traditional lines, which you would look for diversity on.

Heather Shanahan:

Chris, anything to add? Any guidance to offer here?

Chris Krakowski:

Yeah. This is a fun one. We work with a lot of different nonprofit committees, all have different structures and it's really interesting to see the aggregate data from participants. So committee size, for example, six to 10, I'd say anecdotally seems to be a good number to work with. You have enough available positions and committee members for differentiated viewpoints, but not so many that you end up impeding decision making or going down rabbit holes in meetings, so that really makes sense. I'd say one, just again, anecdotal thing to note here, it's always nice to have an odd number of committee members. That sounds strange, but when you get a vote that's close on a recommendation or something, it's nice to have that easy decision maker in the group. So we don't break that out here in terms of committee size, but just something we've noticed over the years.

One thing that does jump out too, I'd say in the member expertise is that 41% finance professional, we see this definitely finance professionals tend to make up the bulk of a lot, or at least they're the largest represented segment in most investment or finance committees. But it is really important, at least in my opinion, to have the diverse expertise. Attorney and accountant at the bottom there really stand out because they really bring a unique perspective to an investment committee, especially as you think about the illiquid investments, legal documents, limited partnerships, it's nice to have the accountants there. You're dealing with issues like UBTI, unrelated business income tax. You're dealing with, again, the legal aspect of these documents. Frankly, just anybody who's not looking at financial markets every day brings a unique perspective and asks really good questions in the meetings. So the more diverse the expertise, the better, we found committees to function over time.

Term limits too, I think that term limits are definitely key. James talked about it earlier, having some sort of formal term limits. It's a delicate balance because you don't want the committee positions to get stale over time, but you also don't want too much turnover. You need that institutional memory to have people who have worked with the portfolio for some time, so it is a balance and term limits do seem to make sense. Again, the majority have them. The one thing I would say is as you think about turning over committees, just ensuring that those term limits are staggered so that you don't end up losing half your committee in one year because all their terms expired. So a nice, even one or two members a year roll up and new people come on makes for a much more, I think, functional committee over time.

Heather Shanahan:

Good deal. Thank you. We have a couple of minutes left, so we wanted to open it up for questions, so we are taking those in the chat. We have one, I'm not exactly sure where this is. So I'm going to read the question then nobody can weigh in. So the question is, funds and/or ETFs versus individual securities?

Chris Krakowski:

Sure.

Heather Shanahan:

Chris?

Chris Krakowski:

It really depends on the organization, I think, and frankly the size. If you have the scale, a separately managed account can be cheaper than ETFs or mutual funds, at least there was in the past. ETFs and mutual funds, the fees have come down substantially, particularly in passively-managed funds where you can get them for close to zero cost, but there are benefits. You don't have a cash drag like you might have in a mutual fund that might hold a couple percent in cash to deal with daily withdrawals, but that works for a large enough pool of assets. You also have higher custody costs with a separate account. So if the pool of money is on the smaller side, separate accounts can work the opposite way and can actually be more costly than a simple structure of mutual funds and ETFs. At least that's been my experience. James, I'm sure you have something to add to this as well.

James Stenstrom:

Yeah. I think, Chris, there's pros and cons with each and the answer may be different for different organizations. I think something though, that I see with organizations using a lot of individual security strategies, it is really important to make sure that the governance and performance reporting is strong. If you have a couple of mutual funds, you can type in the ticker, and say, "Oh," especially passive, on like the index. If you have a laundry list of 50 or 100 or 200 individual securities, and I've seen performance reports where you get, "All right, this is how each one of those 200 positions performed," and you as an investment committee are left with, "Well, does that mean that we did good or bad?"

So I think doing things like consolidated performance reporting, looking at all equities together and doing some of the basic, what I would view as blocking and tackling to make sure that you're evaluating whether your program is successful to objective, independent measures is really important, 'cause I think from my experience as a board member, sometimes I've seen things where I'm surprised. I'm like, "Well, how did the portfolio do?" It's like, "Well, you can see how every individual line item did." I'm like, "I guess that's also important, but I think we're most concerned about what we're doing as a whole." So there's a lot of, I think, value and importance in terms of if you're going to go down that path, making sure that you're reviewing performance in the right way.

Heather Shanahan:

Thank you. The next, it's probably more of a statement, but maybe we can provide some feedback. With alternatives, liquidity can be more challenging when the fund doesn't release the full requested amount. Chris, you want to talk about that for a minute?

Chris Krakowski:

So yes, we talked about illiquid investments and we talked about liquid investments. The one topic we didn't tackle is the blend of those two, which would be either an interval fund or a hedge fund where it's what we call quasi liquid and you put in a request for a redemption and the hedge fund in most cases can honor that request, or typically in the terms of they may be able to give you a small portion and carry that out to their next liquidity window and so forth. The same thing can happen with interval funds. So that is a significant challenge, so we tend to think about those investments. Don't view those as investments that you're going to want to tap into on a regular basis.

Those are investments that you want to almost view as illiquid, but they have the potential benefit of being liquid if you want to reduce that position size. But again, the more illiquid, the truly illiquid investments, you give that, you commit capital and they distribute that capital when it comes back and you don't really have liquidity options. So we've definitely dealt with that many times on the hedge fund

and interval fund side and it can certainly be a challenge, particularly when markets are stressed. When you need the liquidity most is when those funds tend to not have it available, so absolutely a challenge.

Heather Shanahan:

Thank you. I think that's it for questions that we have coming in, and I think we are a couple of minutes away from wrapping up. Again, there are topics we didn't have time to cover in an hour. There's so much content information. James, I'd like to thank you for the tremendous amount of work that you've put into this survey this year and also the past four, so five years here and for everyone who participated and responded. If you're on this call and you didn't respond this year, we'd love for you to respond next year, 'cause obviously the more people we have participating then the better our feedback.

Also, to draw your attention to our podcast Mission + Markets where we did, I think James alluded to the fact we talked about a couple of topic areas that we didn't get to today, so we try not to have some overlap. So feel free to look for that podcast too. We've got some great upcoming episodes there as well. So from all of us here at CAPTRUST, Chris, James, thank you for your time today and thank you for joining us and for participating this afternoon. Have a great afternoon.

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