Nonprofit News Special Report: 2021 Traditional Investments Outlook

Nonprofit investors are expecting positive but muted returns from the equity and bond markets in 2021 after their portfolios generated solid performance in a year that upended global financial markets and saw unprecedented volatility.

While many do not expect the market to perform in 2021 quite like it did in 2020, nonprofit investors anticipate experiencing pressure on their spending targets in the near-term as they gauge the economic cycle’s growth trajectory from fiscal stimulus while the potential for rising inflation enters the picture for the medium-term.

“I think coming into 2020 there was a broad cone of possible outcomes. We think 2021 has a bit of a narrower set of possible outcomes and we feel reasonably confident that 2021 should be a positive economic year just from the recovery kind of making up for lost capacity and lost demand in 2020,” said Kane Brenan, ceo of nonprofit outsourced cio TIFF Investment Management. “Hard to say where the GDP is going in 2021, whether it grows to 3% or 7%, because it’s likely a positive year due to the recovery and that is not usually the environment in which ones sees big stock market drawdowns.”

Anthony Minopoli, president and ceo of the Knights of Columbus Asset Advisors, finds that as investors evaluate factors like the strength of the dollar and equity valuations both domestically and globally to gauge the markets, they must also assess the endogenous shock that has impacted the global population, COVID-19.

“You can’t look at equity valuations and prognosticate where you think the markets will go without understanding what the finish line or at least the intermediate finish line for the virus is going to look like,” he said. “And I think a lot of that has to do with this great stuff that’s coming out of both Moderna and Pfizer and what the distribution will look like. So, we’re looking at both.”
Uncertainty surrounding COVID-19 and the subsequent lockdown and quarantining of many countries led to the end of an 11-year bull market in March 2020. The Dow Jones Industrial Average experienced three record-setting point drops on March 9, March 12 and March 16, while the Standard & Poor’s 500 Index fell 34% to a low of 2,237.4 on March 23.

The markets began rebounding shortly after the treacherous market slides due to the announcement of unprecedented relief measures from the Federal Reserve. Those measures coupled with news of a vaccine and distribution in early 2021 saw the S&P 500 Index close at a record high of 3756.07 on Dec. 31 after hitting an intra-day high of 3760.20.

“The market has been such that, if you just closed your eyes and picked a passive equity index fund, you’ve done really well since March,” said Michael Nguyen, investment director of the Virginia 529 College Savings Plan. “Who would have thought here we are at the end of 2020 and return on equity is better than expected coming out of the end of 2019? It’s shocking to me that market expectations, even without COVID, equity markets were going to be flat to maybe 3% or 4% this year, but that has been blown away.”

In ringing in the new year, the S&P 500 Index returned 16.26%, the MSCI ACWI Index returned 14.33%, the MSCI Emerging Markets Index returned 15.84% and the Bloomberg Barclays U.S. Aggregate Bond Index returned 7.51%, according to data reported by Morningstar and MSCI.

Despite strong 2020 performance and some cautious optimism for 2021, investors and allocators have some concerns regarding the lasting impact of the pandemic and uncertainty surrounding earnings and valuations and sluggish global growth. Those factors coupled with the notion that the markets may continue to be particularly volatile leave investors’ expectations on their equity allocations waning.

“It feels like the market is overbought. We’re nervous about where markets go from here,” said Jack Rich, president and ceo of Abilene Christian Investment Management Company, the investment management arm of Abilene Christian University. “Our public market exposure is relatively low … The market moves don’t help us much when they go up like they are, and they don’t hurt as much when they go down. It seems finding opportunities is more difficult now since we believe returns will be muted in the future.”

Even investors with a more bullish tone on the equity markets still expect muted returns over the course of the year.
“I don’t know if equity returns are 5% or 7%, but the fact that we’ve gotten through a lot of the risks that we’ve seen, whether that be the election or whether that be the world deteriorates into depression, those have kind of moved off the table and those are discounted in the market,” Brenan said. “I think primarily because of the starting valuation in our estimation, you’re not likely to have a year of kind of up 20%.”

Catherine Hickey, v.p. at investment consultant Segal Marco Advisors, sees “single-digit growth for domestic equities” and described her expectations as “solid and positive, but not shooting the lights out,” as the firm waits for the uncertainty around the pandemic to play out more clearly.

The broad sentiment for modest positive equity returns in 2021 is in line with J.P. Morgan Asset Management’s capital market assumptions, which peg domestic large-cap equity compound returns at 4.1%, down from 5.7% in 2020. Those returns trail projections for domestic mid-cap at 4.4% and domestic small-cap at 4.6%, according to the firm’s 2021 return assumptions.

The firm’s assumptions project a slightly more favorable outcome for international and emerging markets equities as they peg compound returns for all country world equity at 5.1%, Euro area large-cap equity at 6.6%, emerging markets equity at 7.2% and all country Asia ex-Japan equity at 7.1%, according to its 2021 outlook report.

“I think when you look across the spectrum of return opportunities, I really feel for those that are still trying to shoot the lights out at a seven plus percent assumed rate of return. That’s a tough nut to crack,” Nguyen said. “Especially when you’ve got best case assumption, if public equities are giving you 6% or 7% and assuming everything else is going to be lower risk and lower return, it’s hard to blend it all together and get to that 7% rate.”

VALUE SLOWLY FINDING ITS WAY BACK AFTER LONG GROWTH RUN

The Russell 1000 Value Index outperformed its Russell 1000 Growth Index counterpart by 20% with 16% less volatility between its inception in 1979 and 2009, while the Russell 2000 Value Index outperformed the Russell 2000 Growth Index by 94% with 25% less volatility over the same time period, according to research from Columbia Threadneedle Investments.

That performance has rotated over the last decade as the Russell 1000 Growth Index has returned 17.21% annually compared to 10.84% for the Russell 1000 Value Index.
Some view the outperformance of growth as an abnormality as the stocks have outperformed relative to their long-term history, while others find it to be a result of the Federal Reserve pushing investors to riskier assets in a lower interest rate environment. Irrespective of what drives the conversation on the strategies, they are an attractive opportunity for nonprofits moving forward.

While Abilene Christian has typically employed a value bias within its equity portfolio, it rotated to more of a balanced approach a couple of years ago. The institution advocates for a more balanced approach in the near-term due to market uncertainty, but sees a possibility of underperformance from momentum and growth stocks.

“Markets are often driven by momentum, and they may be moved to the point of reaching a cliff. It happened in the late nineties. Is this exactly the same? No, nothing is ever exactly the same, but it wouldn’t surprise me to see a correction in some of the high-flying stocks that have been driven by momentum in the large-cap growth area,” Rich said.

KoC’s Minopoli also expressed concern with the large-cap growth segment as “the top five names in the S&P 500” represent “almost a quarter of the index.”

“If I told you that my investment strategy was to take fresh capital and invest more in the stocks that have gone up the most, you would probably look at me like I had four heads and say, why would anybody invest like that?” he said. “But that’s exactly what most passive management is doing. Now you’ve got the S&P 500 with almost a quarter of the value in five stocks and 75% of the value in 495 stocks. We’ve seen this big rotation to small-cap fairly recently. Some are questioning whether the rotation of value is overdone.”
Anthony Minopoli

Investment manager Research Affiliates studied the efficacy of value investments following bear markets and recessions and found that value, quality and small-cap strategies all tend to perform well coming out of the down markets regardless of the catalyst.

Out of the six recoveries studied – the Vietnam War and fiscal tightening; the Nifty Fifty bubble and oil crisis; the Iran oil crisis and Volcker monetary policy tightening; the early 1990s monetary policy tightening; the tech bubble; and the global financial crisis – value outperformed the market five times, each by double digits with an average cumulative outperformance of 24%, according to the research.

The only case when value underperformed in the recovery was the period that coincided with the build-up to the Nifty Fifty bubble from 1970 to 1972, according to the research, which noted that when the Nifty Fifty bubble burst, value handily outperformed growth not only in the bear market but across the full downturn–recovery cycle.

With investors focused on the growth momentum of companies like Amazon, Zoom and Microsoft that have done well with people working from home through the pandemic, Nguyen sees the rotation into value as a viable play for institutions not only because value does well coming out of this type of current cycle, but because “growth can’t keep on this trajectory forever – it’s just not plausible to keep this momentum going.”

“With a vaccine, we should start to see a rotation into value because investors will be bullish on the consumer,” he said. “If things get back to ‘normal,’ people will go back to the office, restaurants and retails will open up and all of the domino effects that go along with that fall into place … I think you’ll continue to see rotation into value and the important fundamentals around balance sheet strength.”

Hickey noted that while the vaccine may lead to a bump in consumer spending that might boost things, “it doesn’t really change this long-term dynamic of the fact that unemployment is still pretty high, labor force participation still isn’t what it should be and some of these longer-term structural issues.”

While the disparity between valuations of growth stocks and value stocks is at unprecedented levels, Cambridge Associates Managing Director Kyle Johnson finds that while the firm may “lean into value” it does not expect to abandon growth because its outperformance “coming from technological disruption” may persist.
"If you have a lot of confidence in the alpha generative abilities of your growth and your value managers, you can maintain both exposures and still outperform. You don’t have to abandon growth to outperform your benchmark. If both sides are generating alpha simultaneously relative to their style indices, you’re still well positioned to outperform. Cambridge Associates is confident that the growth managers we’ve picked will still be able to navigate whatever headwinds they face as some of these valuations come to roost," he said.

Kyle Johnson

Ultimately, investment consultants and advisors are advocating for a balanced approach in the near term.

“It’s difficult to say how different companies are going to perform and with that in mind we love to have a balanced view between value and growth. We recommend that clients keep rebalancing,” Hickey said.

TIFF’s Brenan finds a balanced approach to be sensible, especially since it sees growth’s outperformance as a bit different than some other periods where “growthy companies really accelerate.”

“Companies that are characterized as growth now, some of them are really great businesses with awesome scalable business models,” he said. “You have that dynamic going on where these companies really are growing and have deep moats around them, so they should be valued highly and should be rallying. You also have some of these companies not only pulling forward decades of demand but transitioning client bases that never would have used them. Take Amazon for example. Would my 80-year-old parents have ever used Amazon? No, never,
but when they couldn’t leave the house for six months, they had to learn how to use Amazon. That’s a whole cohort of customers that would not have gotten there later, they never would have gotten there, but they are there now and are likely staying.”

**ECONOMIC DISRUPTION AND SUBSEQUENT RECOVERY PROVIDE OPPORTUNITY FOR ACTIVE MANAGEMENT**

Low interest rates, stable economic growth and low inflation helped fuel the stock market rally over the last decade plus and widen the gap between passive and active investing.

However, the recession and ensuing economic recovery as a result of the pandemic has accelerated trends like the shift to e-commerce. The dispersion created by way of the economic recovery coupled with idiosyncratic risks and potential political disruptions lends itself to a positive environment for active managers, according to investors and allocators.

“Active management feels likely to be more successful than it has been over the last 10 years. It feels likely that we are in a period of excessive valuations,” Rich said. “If so, stock picking will be more valuable in the investment portfolio. Over time, markets adjust to economic reality, but they can be out of whack for a long time. Maybe this is one of those times where it is out of whack. I would expect that indices bear the brunt of a correction.”

The lack of broad success from active management following the Global Financial Crisis has left some investors expecting the tide to come back in for active management, even if fiscal stimulus bolsters corporate profits.

“A market in which the Fed is controlling everything is not ideal for active management, but with that said, a market in which there are winners and losers coming out of the COVID crisis, where there are changing political landscapes, where there’s changing geopolitical
alignment, where there’s some rotation between growth and value and where there’s the potential for interest rates to start going the other way is a potential that we think is pretty good for active management,” Brenan said.

Minopoli finds that investors buying the index for cheap beta makes sense, but only passively investing is leaving returns on the table as there are “real opportunities” in the small- and mid-cap markets that have popped up in the last month and a half.

“As callous as it might sound, we believe it is going to be an ‘adapt or die’ environment. We don’t think just technology companies will survive but believe there are retailers and business services companies that are adapting to this new environment across all market capitalizations,” he said. “Furthermore, if you do your homework and find those companies that are able to adjust and able to thrive, we believe there are some pretty good business stories out there that aren’t just names like Amazon and Google.”

That sentiment was echoed by Virginia 529’s Nguyen, who sees less coverage further down the cap structure in more recent time periods.

“You need a little bit more research and digging and fundamental analysis that make much more of a difference than passing investing,” he said.

When selecting active managers, Nguyen looks for firms with stronger convictions and higher active share, saying, “As managers struggle against passive, and in order to really stand out as a good active manager, you can no longer be that shadow indexer and own 150 to 200 names. Thirty to 50 names in a particular strategy, to me that’s real active management.”

Minopoli sees the work from home scenario as a differentiator of companies in the market moving forward and is looking for stocks that will be positively impacted by this newfound environment.

“We believe those stocks that are going to facilitate working from home and support business to business and consumer spending with this remote lifestyle are the companies that will be able to do well,” he said. “We think those companies that are strictly anchored in brick and mortar and traditional consumption patterns will to be less likely to be able to produce positive results unless they contemplate altering their business model.

With expectations for muted returns, active managers’ ability to outperform passive indices will be that much more important for nonprofit investors to reach their spending plus inflation targets.
“Active management is a requisite skill set today,” Brenan said. “I’m not so silly to say I know when active is going to outperform passive, but I do know the math says that you need to achieve active management to try to get to most clients return targets. One way to do that is to kind of look around the globe for places that are the least researched, the least efficient, so that’s how we’ve constructed our endowment portfolios.”

The least efficient, least researched areas appear to be small-cap, emerging markets and developed international markets and all are shaping up to be a “a stock pickers’ paradise due to the huge volume of names,” according to Minopoli.

**LOOKING BEYOND THE U.S. FOR BETTER VALUATIONS, CAPTURING LONG-TERM TRENDS**

With return expectations for domestic equity looking solid yet unspectacular after another strong but volatile year following a historically long bull run, investors and allocators are shifting some of their focus overseas.

The shift in focus toward international and emerging market stocks is largely driven by the U.S. market’s increasingly heady valuations, which could prove to be a substantial headwind to investors.

“We acknowledge that the recent history of U.S. outperformance makes this a challenging notion for many investors,” according to J.P. Morgan’s Long-Term Capital Market Assumptions report. “However, long cycles of U.S. outperformance followed by long cycles of underperformance are not unprecedented. The current cycle, more than 10 years of U.S. outperformance – though it has not yet reached the scale of the late 1990s – may well be due for a reversal.”

That sentiment was echoed by Abilene Christian’s Rich, who could see a rotation into international and emerging markets.

“If domestic markets are highly valued, and the relative valuation in other markets is lower, then values may increase in the undervalued areas,” he said. “So, I would expect some of that to happen. We have a reasonable allocation to international and emerging markets. While that hasn’t been a great place to be over 10 years, it has not been a bad place for us over the last year or two.”

Nguyen sees international developed equity markets as attractive and pointed to Japanese and European equity markets due to their reasonable price relative to domestic stocks.
**Schroder Investment Management** sees potential for European equities due to more balanced sector exposures and a transition to a more green, sustainable and digital economy, according to recent research.

“One of the challenges with the developed markets is that the monetary levers are not fully exhausted, but they’re kind of at the end of what they can do so, you need a lot more fiscal support,” Cambridge Associates’ Johnson said. “Obviously getting fiscal support through is always a political challenge and we can see that in this country, and we can see that in the European Union, where they passed a pretty big stimulus package, but the devil’s in the details and they’re still running into arguments and challenges over there in actually implementing it like we’re finding here.”

Japanese equities are an attractive play for some investors due to the country’s political stability, low valuations, compelling dividend yields and potential for a strong recovery due to low unemployment allowing a relatively quick restart in manufacturing, according to research from **Lazard Asset Management**.

In the emerging markets segment, Rich noted that not all emerging markets represent an opportunity and he is most compelled toward opportunities in South and Southeast Asia, including China and India.

“The emerging economies are all looking for the same thing – they want better growth, a better life, better schools,” Rich said. “If you can get the flywheel turning and get economic improvement in India like you saw in China, then I think there will be numerous opportunities.”

The university has significant exposure to China relative to other endowments and does not plan on increasing its exposure as the opportunity set is tempered by uncertainty with China’s geopolitical risks, according to Rich.

Johnson noted that the firm has “modest tactical bets” with the Chinese A-share market, which was put on in early 2019 when the market was depressed.

“The A-shares market has really rebounded quite strongly over the course of 2020, yet valuations still look, in our view, compelling relative to what we see with developed equities and U.S. equity in particular,” he said. “I think that position’s likely to persist just given the supports that we can see economically and the supports valuation-wise suggests that there’s probably still more room to run in the Chinese A-share market.”
Johnson noted that outside of Chinese valuations being compelling, they are much further along in their recovery from COVID and “have more firepower should their economy struggle in terms of starting from a higher interest rate point.”

Brenan also looks at Chinese equity investments in a positive light saying, “not only did it emerge first from the virus downturn, but it also may have even benefited a little bit in the sense that there were some places around the globe where capacity was taken offline and China was still open for business because they reopened quicker.”

TIFF also views China as attractive because of the potential lack of correlation to the U.S. in the future.

“One thing you try to do as an allocator of capital is you try to have diversification and you try to pursue modern portfolio theory and have things that don’t go up and down in unison. In one sense, the geopolitical dynamic of some of the ties between China and the U.S. becoming less would actually argue to have more money in China because it’s likely to have a lower correlation moving forward. Before you had to ask if you go to China is that really diversifying away from U.S. when a chunk of your demand and a chunk of your supply comes from there? To the extent that these big superpowers separate a little bit, those economies may be less correlated with each other and from an asset allocation perspective it would argue to have a little bit more there because they’re not going to necessarily go up and down in unison. “

Despite the argument for increased exposure, Brenan said TIFF is taking a deeper dive into China to determine how much of their recent economy was from transitioning to a consumer economy and how much of it “was indirectly benefiting from the fact that they were the only store open on the block.”

Ultimately, investor interest in international and emerging markets in the near term will be driven by valuations, while their long-term exposure to the geographies will be driven by more macro themes like demographics and the rise of the middle class.

**NONPROFITS CONSIDERING ESG AS MORE NEED THAN WANT MOVING FORWARD**

The COVID-19 pandemic has added heightened attention on structural issues including a focus on sustainability and inequality, according to investors and allocators.
“This shock is a dress-rehearsal for disasters like those seen with climate change. Politics may listen more to science,” said Carole Crozat, head of thematic research at BlackRock, in the firm’s 2021 global outlook report.

BlackRock is bullish on ESG and sustainable investments moving forward as areas like the European Union and China have released more ambitious targets for reaching net-zero carbon emissions, which will require major investment to ensure a green transition, according to the report.

The firm also pushed back on the notion that the green transition will weigh on growth as it expects extreme weather and other effects of climate change to reduce potential growth in future decades, saying “efforts to mitigate the damage from climate change should boost economic growth relative to this new baseline.”

The firm views carbon efficiency as a key differentiator that will drive a repricing across sectors and companies in the future, according to the report, which noted that the firm will tactically implement the idea through a barbell approach that favors technology, healthcare and selected cyclical exposures.

Rich finds that environmental issues will be an investible theme for a long time to come.

“We have over 10% of our portfolio now funded or committed in renewable energy or renewable themes. Peers who know something about our portfolio may see us as being overly exposed to oil and gas, but that’s not quite right … We also like renewable themes. We see opportunities in wind and solar power development, battery technologies as well as in the commodity space for those minerals that will be needed to fuel an increasingly electrified future,” he said.

Over shorter-term horizons Rich is focused on “transitional” types of assets such as natural gas, which burns cleaner than coal and can reduce carbon emissions as other cleaner fuel sources are developed to provide the grid with consistent power.
“We need natural gas to replace coal as a transitional fuel … Carbon fuels drove the world’s economic rise over the last hundred plus years. Economic growth has been a carbon-based phenomenon, whether its coal, gas or oil. I’d be delighted for the world to get away from carbon-based energy, but it’s not going to happen overnight,” he said.

While Rich is focused on renewable and sustainable investments, he noted that “good governance should have triple the weight” of the environmental and social factors.

KoC manages its assets **in full compliance with the United States Conference of Catholic Bishops** socially responsible investment guidelines and finds that ESG factors, particularly environmental and governance characteristics, are going to lead to better portfolio outcomes, according to Minopoli.

“Now that doesn’t mean we will not own companies that are not at the highest level on ESG ranking, but what it does mean is that we’re going to expect a higher risk adjusted return in order to justify the placement of that security within our portfolio,” he said, giving the example of an industrial company.

If the industrial company handles its environmental waste problems that is a positive that is going to benefit the company and investors.

“By doing the right thing, it means management is not going to be subject to lawsuits or government scrutiny. If management can adhere to the strategy they’re trying to employ, don’t have the linkages of lawsuits or fines or government intervention and can keep their eye on the ball, in my view it will allow them to move forward,” he said.

As investors continue to be drawn toward ESG investing, Rich finds that the way strategies are marketed and described can be “extremely confusing and somewhat dangerous for investors.”

Virginia 529’s Nguyen agrees with that sentiment and finds that ESG principles leave a lot of subjective decisions.

“You have managers out there that are slapping ESG on as a label for a strategy and it’s attracting flows because it’s got the ESG label on it. Underneath the hood is it truly a fundamental ESG approach or is it they are just buying ESG data from MSCI or S&P or whomever and essentially running an index fund?” he asked. “I applaud managers that build
onto an in-house research team and execute ESG research themselves. Ultimately, ESG is a marriage between the investors’ desire to adopt ESG principles and picking the right manager to partner with. It simply goes back to fundamental research.”

The difficulty for nonprofits in the ESG space is the nuance related to their objectives, the mission they are trying to accomplish, the outcome they are seeking and the impact they are looking to achieve, according to Brenan.

That individualization beyond making an impact while achieving high returns with low risk is crucial for investors as they make the investment theme fundamental to their research and investment process.

“There are many ways to go about ESG investing and that’s part of the opportunity and that’s part of the challenge,” Segal Marco’s Hickey said. “As it is becoming more popular and more widespread the ESG strategies are only going to grow. It’s incumbent on investors to develop an approach that works for them that takes into account their own criteria and values and mission.”

**FIXED-INCOME: MORE QUESTIONS THAN OPPORTUNITIES**

Investor and allocator expectations for fixed-income moving forward are positive but significantly toned down coming off of back-to-back high-single-digit returns in 2020 and 2019.

The fixed-income asset class’ opportunity to outperform is likely to rely on a confluence of events from the efficacy and distribution of the COVID-19 vaccine to fiscal stimulus’ ability to shore up the economy, while the impacts of challenged economic and corporate fundamentals and uncertainty around the direction of President-elect Joe Biden’s administration are sources of potential volatility spikes to monitor.

“Bonds have been on a tear recently, and spreads are tight; everything has been priced for perfection,” Minopoli said. “The reality is that there’s still a lot of scared people out there, and there’s a lot of money hiding out in fixed-income, which is one of the reasons that we’ve seen spreads grinding as tight as they are. If you’re running an endowment or foundation today, quite honestly, what you’re trying to balance are the concerns over inflation and rising rates because nothing erodes the value of a bond portfolio more than rising rates. And secondly, where the heck do I go to generate income?”
Hickey thinks that fixed-income returns will be more muted in the near-term relative to long-term expectations due to low current interest rates and the expectation they will remain low.

The Federal Reserve announced on Dec. 16 that it would “keep the target range for the federal funds rate at 0 to 1/4 percent” with the expectation that it would maintain the target range until labor market conditions reach “levels consistent with the Committee’s assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time,” according to a statement from the Federal Open Market Committee.

The Fed statement leaves investors expecting little to no interest rate movement in the beginning of the year as it hopes to keep investors invested in risk-on assets, while providing a glimpse as to what it will take to see an interest rate increase.

“The front end is unlikely to go up by a lot in the near term, but the back end if you start to see that creep up, that could be a real headwind,” Brenan said. “I think the market can withstand rates going up at a judicious pace because that’s good rates going up, which means there’s reflation, growth is coming back, the world's returning to normal. But if the 10-year starts jumping 50 or 60 basis points in a month for example, if it goes up too quickly, then people say, ‘uh oh, inflation is coming and I also have to totally change the discount rate on how I’m valuing stocks.’”

Hickey also noted that areas associated with higher return outcomes like high-yield and bank loan investments are in line with long-term assumptions, which she described as “steady” and “nothing outstanding, but nothing terrible either.”

J.P. Morgan’s compound return assumptions for U.S. Long Treasuries have dropped to 0.4% in 2021 from 1.6% in 2020 and 3.25% in 2019, according to its 2021 return assumptions. Projections for U.S. Aggregate bonds are higher with a projected compound return of 2.1%, which is down significantly from 4.1% in 2019. Leading the firm’s assumptions domestically are high-yield bonds and leveraged loans with compound returns of 4.8% and 5.1%, respectively. In looking internationally, emerging market local currency debt and emerging market sovereign debt are pegged highest across strategies with a 5.2% compound return.

The return expectations make it hard for some investors to justify fixed-income investments in the portfolio if they are set on hitting their yearly return targets, some investors and allocators said.
“There’s certainly a case to be made that there’s room for one more down leg in the U.S. with rates going to zero like they are in much of the rest of the world,” Rich said. “But then you are not investing for income return, you are investing for capital gains. If you are investing for capital gains, then it may work for maybe another 20% gain. The trade-off between the downside risk of very low current income and the upside risk of a continued drop in interest rates is not worth the risk allocation.”

Brenan is concerned with fixed-income managers’ ability to provide yield and diversification “like it used to,” which has pushed TIFF to employ hedge fund and alternative managers to achieve those benefits.

“We are very cognizant that they are not going to provide us the negative correlation. They’re lower correlation obviously than equities, but they’re not going to provide us the negative correlation that fixed-income used to provide you in an equity drawdown,” he said. “You need to find some assets that have actual negative correlation and some of it may be as simple as buying some equity puts when they are on sale.”

**INFLATION CONVERSATIONS POPPING UP**

The annual inflation rate in the U.S. sits around 1.2% through November 2020, well below the Federal Open Market Committee’s goal of “moderately above 2 percent for some time so that inflation averages 2 percent over time.”

The inflation rate should not be of concern to most investors due to unemployment at elevated levels and a weakened economy at this point in time, but institutions should begin to discuss inflation pressures over the medium term as investors expect the economy to recover following a return to normalcy post-pandemic.

“I think inflation will follow in the long-term if there’s more monetary stimulus, if fiscal stimulus ever comes and if the economy does improve that, then there could be the kind of inflation that might affect bonds and make rates go higher,” Hickey said.

Brenan said inflation seems to be a lower likelihood event in the coming year or two but sees “some big picture things that could stir it up.”

“With the Fed’s new reaction function of targeting average inflation, globalization pausing and maybe retracing and the U.S. working its way out of a massive debt overhang we could see inflation, certainly above the roughly 1.5% that we’ve had over the past decade,” he said.
Virginia 529’s Nguyen said he has concerns about inflation outside of the next 18 months saying, “the Fed gave themselves a lot of latitude by generally saying we’re comfortable with letting inflation run. I think that’s their way of saying they may not even have comfort or confidence in the 2%, 3% rate that they set for themselves.”

At the same time, Nguyen looks at Japan and Europe and the demographics of their aging populations, which has caused their inflation to be “non-existent.”

“You wonder if we’re not too far behind in the U.S. Whether it’s immigration policy, low birthrates, our demographics are getting older as well. We have been in a low inflation environment and I think with the efficiency in distribution and competition for pricing goods and services, inflation is muted to most consumers,” he said.

As conversations and concerns about inflation pop up more in investment committee meetings and conference calls, Hickey reiterated the importance of a well-diversified portfolio that considers those factors.

“Some clients have TIPS exposure, inflation index exposure and that’s part of a long-term strategic allocation. Those that don’t have that exposure may begin looking at the space,” she said.

Cambridge Associates’ Johnson noted that the firm has already put on “a slight overweight to Treasury inflation-protected securities.”
“Not so much because of the fear of severe inflation or anything like that, but because the breakeven inflation rates implied by market pricing are on the low side,” he said. “That makes us think that we might be in store for some inflation surprises to the upside, which would put TIPS in a good position to benefit from that.”

SEARCH FOR YIELD LEAVES INVESTORS EXAMINING HIGH-YIELD, CREDIT & EMERGING MARKET DEBT

Traditional fixed-income will continue to play a role as a ballast in nonprofit portfolios in a downturn or as liquidity in a dislocation, but the investments do not provide enough yield to help the institutions reach their spending plus inflation targets.

“We believe that management is still going to need some level of fixed-income for liquidity and also risk management, but will need to look at the senior loan market, mezzanine debt and preferred stock as these areas provide income,” Minopoli said, noting that perpetual preferred stock of major banks that still generates a high-three or low-four handle dividend.

The fixed-income market has been supported by the Federal Reserve purchasing Treasury securities and creating an artificial risk-free environment for investors, which has lowered yields on the coupon side and left investors searching, according to investors and allocators.

“Historically, 75% of returns in [the] fixed-income market come from coupon payments. If that’s the case, the only opportunity that exists for any returns in this market is to put on risk to generate 3.5% to 4% return within your fixed-income bucket,” Nguyen said. “You have to be willing to take duration risk and credit risk, so I think bank loans and high-yield obviously articulate those strategies.”

Investors’ ability to be diversified and concentrated in higher quality credits will be crucial for their investments over the near-term with so much uncertainty in the world and market, according to Hickey.

“We’ve seen pretty strong issuance [within high-yield] still, but if there’s an any other kind of an economic hiccup with, depending on how things kind of roll out next year, the risk of defaults could go up. Right now, spreads are kind of in line with their historic median, so we’re at the point of concentrating on relatively higher credit quality in high-yield,” she said.

Hickey noted that Segal Marco is also looking to employ more active management that “can really pick out credits that can outperform in this kind of an environment,” she said.
That sentiment was echoed by Nguyen, who has seen a move toward passive management in the broader more liquid fixed-income market.

“When it comes to high-yield, when it comes to bank loans, when it comes to multi-sector or multi-credit those are still active markets and active managers will make a bigger difference in those strategies,” he said.

Johnson finds that spreads are tight in many bond sectors, with high-yield spreads compressing to near 400 basis points from a peak 1,100 basis points in March, which is roughly 15% below their historical median, despite elevated default rates and rising corporate leverage.

“It’s hard to find niches that are particularly attractive across the liquid bond space. There’re a few little spaces, but across most of it the spreads are not particularly compelling right now,” Johnson said. He noted that the firm is not exploring high-yield “in any great depth” as the role of the strategies is often covered through its hedge fund allocations.

Rich carried a similar sentiment and finds it difficult to justify high-yield investments unless an investor is desperate for yield.

“High-yield pricing is not worth the return that you can earn today. I think there’s more risk than what the return would indicate,” he said. “I’ve never been a big fan of some of the direct credit strategies because I don’t know who’s making those decisions and I don’t know who monitors that risk. When you had banks, at least you knew the controller of the currency or
the state regulators were watching loan risk. Today, I don’t know who’s managing that risk. I
don’t think high-yield is a diversifying asset to your equity exposure, at least not like U.S.
Treasuries were in the past. The credit risk is not a fixed-income exposure from my
perspective.”

He also noted that in the event of a market correction, high-yield will get “hit early and fast.”

Nguyen will continue to monitor default levels as they pertain to high-yield investments
because “the expectation is that if the economic cycle comes back to what it was and people
are spending with some normalcy, then default rates should stay below average and we
should see potentially better returns coming out of high-yield.”

He noted that is “a big qualifier, if downgrades and defaults remain lower or as low as they’ve
been over the course of the last three to five years.”

Cambridge Associates finds that current credit spreads “could represent fair value if the
current default cycle is near its peak,” but noted that if COVID-related shutdowns are
extended or if reduced demand for some companies becomes permanent, defaults could
become more common across sectors, according to the firm’s 2021 outlook. The firm finds
that nearly 80% of defaults this year involve energy and telecommunication companies.

**Wellington Management Company**'s 2021 fixed-income outlook sees less opportunity for
structured credit investments post-pandemic as malls and other retail businesses face stiffer
headwinds than before the global contagion event, while hotel and office properties are also
challenged.

The firm's outlook finds that the mezzanine areas of structured credit are likely to see 100%
losses for certain tranches and “enticing yields unlikely to be realized in many cases.”

The firm points to one bright spot in the area, securities exposed to residential housing.

“Housing prices remain buoyant amid continued low mortgage rates, fiscal stimulus, and a
favorable supply-demand dynamic that has persisted since the global financial crisis,” the
outlook states.

Investors will have to look outside of their comfort zones in the near-term if they expect their
fixed-income portfolios to help meet spending and return objectives.
“We believe investors need to be a little bit more thoughtful, a little bit more broad thinking. Whether it’s senior secured loans, private loans, mezzanine debt, real estate mezz, senior real estate lending or opportunities where, I know it doesn’t sound like much, but when you can still get three and four handle paper to provide some level of income,” Minopoli said. “I believe because traditional investment grade fixed-income is so tight and priced for perfection that investors will need to be thoughtful and maybe talk to a different squadron of managers than they have normally spoken to in the past.”

Cambridge Associates highlighted collateralized loan obligations as an attractive investment opportunity as the prices offer cushion if conditions deteriorate unlike other publicly traded assets that have been picked over.

“CLO mezzanine debt remains attractive. Distributions have been maintained, and defaults in underlying CLO pools have been much lower than broad market averages,” the firm’s outlook states.

Nguyen pointed to bank loans as an area of interest, even if other investors are not keen on the strategies after the near-zero interest-rate environment pushed down the loans’ total yield.

Wellington finds that “bank loan spreads were recently in the top quintile versus their history” and represent one of its highest-conviction investment ideas for multisector portfolios.

The firm’s 2021 fixed-income outlook finds that default rates have increased with some high-profile loans defaulting with expectations of “very low recovery rates.”

“However, we believe these concerns are more than adequately priced into today’s attractive loan spreads. On average, loans still tend to experience higher recovery rates than comparable bonds, while also typically offering similar or better credit spreads. Despite recent retail outflows, the technical backdrop remains largely supportive, thanks to strong demand from collateralized loan obligations (CLOs) and limited new issue supply. We currently see the best opportunities in higher-quality, US-focused loan issuers in less cyclical industries,” the outlook states.

Bank loans’ floating rate, a natural hedge against inflation, mark them as an area of interest in Nguyen’s eyes.
“We won’t earn as much as high-yield, but I get comfort in that if the Fed comes in earlier than expected and raises rates then I’m somewhat protected by the floating rate nature of the payment stream,” he said.

The uncertain outlook and low yields should also lead investors to look outside their home markets in 2021 as other countries do not have the same resources to support struggling companies like the U.S. and Europe.

Cambridge Associates finds “a variety of opportunities in emerging markets, including buying non-performing loans from local banks and stepping in to buy discounted claims from cash-starved companies” as the markets see less competition for deals, raising the chances that returns will be higher.

Nguyen sees emerging market debt as a viable investment opportunity, particularly if global economic growth stabilizes and begins to recover following the pandemic.

“During the recovery of the credit squeeze spring of this year, you had an investment grade recovery very quickly because the Fed came in and supported it, and then you had investors worried about defaults and piling into investment grades because those are the safe havens and give you a better return stream and profile than pure U.S. government bonds,” he said.

“As the recovery cycle continues, EMD is the last to recover. From an opportunistic perspective, if COVID is under control and U.S. and developed market activity start to hum again, then EM is the large recipient of the tail end of the recovery; especially EM markets that have exposure to energy. If the demand for energy and oil participate in the economic recovery, I think EM markets will do very well.”

Wellington finds emerging market corporate debt issuers offer more opportunities as company fundamentals vary by industry and are often not overly linked to the fortunes of the home countries.

“Our preferred credits have demonstrated resiliency in a difficult environment, with management teams that emphasized debt reduction, moderate capital expenditures, and prudent balance sheet management even prior to the crisis,” the firm’s outlook states. “As business activity and corporate earnings recover, we expect many issuers to naturally reduce leverage, which they have generally not needed to the same extent that many sovereigns have.”
The firm also sees some opportunity in emerging market sovereign debt and to a lesser degree select frontier markets, favoring those with low repayment needs over the shorter term to allow those that are willing to do so time to address their macro and fiscal challenges, the outlook states.

“We’re steady on emerging market debt. We’ve seen countries’ balance sheets in emerging markets improving, but there’s still a lot uncertainty in emerging markets at this point, especially in the near-term just country by country with COVID responses and COVID levels varying,” Hickey said. “Central bank stimulus from country to country is different, so it’s something that we’re watching, but the uncertainty gives us pause on being overweight.”

She finds that active management will be important in the space moving forward “to navigate the very unique climate we’re in right now” and the “unknowns of how the pandemic will continue to play out.” Hickey noted that investors must be cautious with broad emerging market indices as China has propped them up due to its ability to manage the pandemic and improve its economy.

**ALTERNATIVE INVESTMENTS AS A FIXED-INCOME SURROGATE**

Investors and allocators expect the demand for private credit and alternative investments like hedge funds to grow as a substitute for traditional fixed-income investments because of their higher-yield returns and illiquidity premium.

Nguyen sees more fundraising on the horizon for private credit and debt strategies and is interested in more core-plus types of strategies that could range from “asset-based lending to equipment leasing to real estate lending to maybe more direct lending on the large cap side of a deal” with returns in the 8% to 12% range.

Other investors, like Hickey, are less interested in the arena as there is “too much money chasing too few deals in private debt.”

“It’s a little bit challenging with so much money with so few options for yield in public fixed-income,” she said. “We’re even seeing institutions going into private fixed-income and driving down yield there as well. It’s a problem across the board for institutions and it’s not changing anytime soon with rates so low.”

TIFF’s Brenan also takes a more bearish approach on private credit strategies because of the firm’s preference for higher returning asset classes.
“One of the most valued things in the marketplace is being liquid. To the extent you’re going to have capital that’s illiquid and non-accessible, we’d rather use it in the highest returning asset classes,” he said. “Those people that are moving from the Barclays Cap Agg or from high-yield to private credit are implicitly saying, ‘I’m going to take more illiquidity risk.’”

For investors interested in the private credit space, Minopoli strongly advocates for increased diversification among managers and not chasing the “hot dot.”

“As a cio who would normally split $50 million across one or two managers, I would advise them to split the $50 million allocation across maybe seven or eight managers to spread out the risk and ensure their organization is broadly diversified,” he said. “I believe this strategy makes a lot of sense, but as with any individual mezzanine loan or senior loan, things are going to go bump in the night. We’re still not through the crisis, we’re still not through the virus. I believe that while broad diversification may dampen down an organization’s return a little bit, right now it’s is going to be your organization’s best friend until we get to the other side.”

Outside of private credit, investors may look to uncorrelated, absolute return and hedge fund strategies to increase their portfolio’s returns without taking on much equity risk or illiquidity, according to Johnson, who noted that they are not without their own risks.

“There’s a lot of trade-offs though. Bonds give you better liquidity and they have a much more certain low correlation to equities, while hedge funds don’t typically give you that certainty. I think there’s a lot of risks that we’re going to have to explore and weigh if we move in that direction,” he said.

Johnson noted that Cambridge Associates often takes a barbell approach to its “evergreen” hedge fund structure employing long/short strategies that provide betas of roughly 0.5 to 0.7 and absolute return strategies that are closer to zero to 0.2.

“By barbelling those two, we get to 0.3 and that doesn’t change all that much. We’re not particularly tactical within the hedge fund allocation, but I could see us expanding a little bit into some of those lower beta strategies and offsetting that by underweighting the bond allocation as a way to pick up some return,” he said.

Ultimately, investors anticipate they will need some less traditional investments to generate a diversified portfolio that helps them reach their spending and return targets.
“You’re going to have to look at some asset classes that maybe you traditionally never considered in order to put on the hunt for a little bit of income to stand alongside your capital gains seeking investments both in public and private equity,” Minopoli said.

He went on to add that “private assets can move along quite nicely with public assets and organizations can build a very well diversified portfolio that provides yield opportunities, and the needed liquidity to meet the spending that foundation and endowment managers are constantly asked to fund, just by the very nature of the assets they manage.”