



Looking backwards and forwards



Reaching objectives for non-profits

Russell Investments Research



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The typical endowment or foundation bases its long-term return objective on its long-term spending rate plus inflation. It then designs its strategic asset allocation around that return objective, assuming it has the risk tolerance to do so.

A common way of analyzing the strategic asset allocation is to assess the likelihood of achieving the return objective over the next five, 10 and 20 years. This means that the market return expectations at the time of the analysis are a critical variable in the determination of whether the organization is taking enough market risk to achieve its objective. This is sensible, as it is important for an organization to know whether it can achieve its desired objective in the current market environment.

When looking at historical returns, there is endpoint sensitivity to the values, but there is also starting-point sensitivity in capital market expectations. Elevated market levels (i.e., high P/E levels in equities and low interest rates in fixed income) lead to lower expectations for forward-looking returns, which means that the market valuations at the point of the analysis impact the return expectations. This approach could compel an organization to increase its equity allocation when market valuations are highest, as it will need more equity to achieve the same total portfolio return given the reduced forward-looking return expectations. Typically, elevated market valuations are caused by higher-than-expected historical returns that have allowed the organization to outperform its objective over recent history. Should the organization account for this by not expecting the investment portfolio to reach its objective over the next 10 years? This could lead to comparing the objective to a holistic time period that is inclusive of the future and recent history. By integrating the endpoint-sensitive historical returns with starting-point sensitive capital market expectations, we can reduce the impact of the chosen starting date of the analysis while still accounting for current market conditions.

Return experience over the past decade

If, on December 31, 2009, a client wanted to achieve an objective of CPI+4% with passive beta exposure, we would have noted that a passive portfolio with 80% in

global equity and 20% in core fixed income would have a 50% likelihood of achieving that goal. Ten years later, on December 31, 2019, equities would have significantly outperformed expectations, and that asset allocation strategy would have earned a total return of 8.4%, equivalent to CPI+6.5%. This would be great news, and the return would be in line with the 69th percentile of the expectations from December 31, 2009.



Market returns were so strong at the end of 2019 that even after the extreme first quarter drawdown in 2020, the historical 10-year return on March 31, 2020, would have still been closely in line with the original expectation.

Exhibit 1 shows expected 10-year returns from December 31, 2009 and contrasts them with returns 10 years later.

Exhibit 1: 12/31/2009 expectations relative to actual returns 10 years later

	GLOBAL EQUITY	US AGG	80/20 (NOMINAL)	80/20 (CPI+)
12/31/2009 median expected 10-year return ¹	6.5%	4.9%	6.4%	4.0%
10-year annualized return at 12/31/2019	9.4%	3.7%	8.4%	6.5%
10-year annualized return at 3/31/2020	6.4%	3.9%	6.2%	4.5%
10-year annualized return at 12/31/2021	12.4%	2.9%	10.7%	8.3%

Market returns were so strong at the end of 2019 that even after the extreme first quarter drawdown in 2020, the historical 10-year return on March 31, 2020, would have still been closely in line with the original expectation. And the portfolio would have outperformed its objective of CPI +4% as actual inflation was lower than what was expected back in 2010. Equity markets then rebounded at an unprecedented pace, and the bull market continued over the next year and a half with the realized 10-year returns at December 31, 2021 well above capital market expectations. On December 31, 2021, the portfolio would have achieved a 10-year return of 10.7% or CPI+8.3%.



Equity markets then rebounded at an unprecedented pace, and the bull market continued over the next year and a half.

¹ As of 12/31/2009 Russell Investments only produced one set of forecasts, which are in line with our current strategic planning forecasts.

Understanding return expectations through time

The bad news on December 31, 2019 and December 31, 2021 would have been that we would have assessed equity market valuations as high, lowered return expectations and concluded that the likelihood of achieving CPI+4% over the next 10 years is low. This change in expectation is actually due to those great historical returns in the preceding periods. As rising equity valuations fueled the equity market performance, we then accounted for the elevated valuations and had more muted forward-looking expectations for equities. The organization has two immediate options that are typically discussed:

1. Increasing risk in order to increase the likelihood of reaching its objective; and,
2. Changing its long-term objective.

With 80% in equity, the recommendations to increase the expected return would likely involve the inclusion of active management and alternatives strategies, which we would normally recommend to clients as a way to improve risk-adjusted returns. But, for the purpose of this discussion, we are assuming a simple passive portfolio. The other option that is often left unsaid is doing nothing and just accepting a reduced likelihood of the organization achieving its objective in the future.

Now, if we contrast calendar ends 2019 and 2021 with March 31, 2020, equity valuations were much more attractive given the declines in equity markets in the first quarter of 2020. The likelihood of achieving CPI+4% was 52%. Nothing changed in the portfolio construction, but due to the decline in equities, markets were considered more attractive, and it was assumed that it would be easier to achieve the investment objective. However, an organization with an 80/20 portfolio would have just experienced a significant drawdown so the improvement in forward-looking expectations merely helps to offset that real loss when projecting the asset base forward. **Exhibit 2 demonstrates the extent to which forward-looking returns changed from December 31, 2019, to March 31, 2020; and then to December 31, 2021.**

Exhibit 2: Comparison of 10-year return median expectations² at 12/31/19, 3/31/20 and 12/31/21

	GLOBAL EQUITY	US AGG	80/20 (NOMINAL)	80/20 (CPI+)
12/31/2019	4.3%	2.8%	4.1%	2.1%
3/31/2020	6.8%	2.1%	6.0%	4.2%
12/31/2021	3.6%	2.4%	3.5%	0.9%

² Based on Russell Investments' Market Conditional Forecasts

Integrating historical returns with forward-looking expectations in objective settings

The setting of the strategic asset allocation should not be entirely dependent on the market valuations on the date of analysis; however, it should account for the likelihood that the portfolio will meet its investment objective given the current market environment. We recommend that organizations consider explicitly looking at how the investment assets have recently performed relative to the organizational objectives and account for that in the forward-looking analysis.

As of December 31, 2019, and December 31, 2021, the organization would have outperformed its objective over the past five and 10 years. A holistic approach would look at the likelihood of reaching the objective for a time period that includes both historical returns and future expectations. The time periods could be customized by the organization. **For the analysis in Exhibit 3, we included five years of historical returns and 10 years of future expectations to create a 15-year horizon.**

Exhibit 3: Likelihood of achieving objectives for an 80/20 portfolio based on future expectations or inclusive of historical returns and future expectations

	12/31/ 2019	3/31/ 2020	12/31/ 2021
Typical approach			
Likelihood of CPI+4% over next 10 years	31%	52%	20%
Alternate approach			
5-year historical return above CPI	5.8%	2.0%	9.7%
Return above CPI required over next 10 years (e.g., 12/31/19-12/31/29) to achieve CPI + 4% over a rolling 15-year period (e.g., 12/31/14-12/31/29)	3.1%	5.0%	1.3%
Likelihood of CPI+4% over a 15-year period (e.g., 12/31/14-12/31/29) inclusive of past 5 years and next 10 years	40%	43%	46%

Solely looking at the likelihood of CPI+4% over the next 10 years would lead to very different assessments of whether the portfolio is expected to achieve the required objective. This could cause an organization to increase its level of growth assets when markets are least attractive. This is due to the sensitivity of the expectations to valuations on the date of the analysis. Looking at a time horizon inclusive of both historical and expected returns would not only lead to greater stability in the asset allocation process, but also lessen the assumed need to increase the allocation to growth assets just after strong equity returns have been earned. This occurs because

although the forward-looking expectations are starting-point sensitive, these expectations are often counter-balanced by the end-period sensitivity of the historical returns.



Looking at a time horizon inclusive of historical and expected returns would lead to greater stability in the asset allocation process.

This raises the question of whether we should simply ignore market conditions in setting the strategic asset allocation. We believe market conditions should *not* be ignored, as it is important for investors to have a realistic understanding of what can and should be expected in the future. However, incorporating both historical returns and future expectations will give organizations clarity on the impact of their decisions. This could provide a rationale for not adjusting the portfolio to undertake more risk when market expectations are the lowest or not reducing risk when market valuations are attractive.

This approach of incorporating both historical experience and future expectations is likely most appropriate for organizations that have not spent, or budgeted to spend, their historical gains and instead are slowly increasing spending. This is likely to be the case for organizations that strictly follow policies using a hybrid spending approach, percentage of assets or a fixed spending model. This holistic analysis is beneficial for organizations that require greater stability. It lessens the impact of the exact date used to estimate future returns for the strategic asset allocation analysis.

However, some organizations will have already spent their additional gains or harbor a behavioral bias that leads to the expectation to spend off the higher current asset base. If this is the case for your organization, then you may not want to rely on the approach suggested in this paper and will likely need to continue to target your original objective on a forward-looking basis. This is likely to occur if the official spending policy is only loosely followed, with the desire to adjust annual spending based on assessed needs and asset growth.

The exact way historical returns should be integrated into forward-looking analyses of meeting objectives will vary by organization. Some organizations—such as those that have already spent excess historical returns (or have budgeted these for spending)—may not want to incorporate this approach at all. Others may find it useful for looking at objectives and determining what should be targeted going forward from a given point in time. The impact of changing the spending rate could also be incorporated into this analysis, as a reduction in the future spending rate would further reduce the required going-forward return. There is no one-size-fits-all solution; however, just as organizations have traditionally looked at the interaction between spending and expected returns, we would encourage them to add the impact of historical returns to the analysis and conversation.

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