Looking backwards and forwards

Reaching objectives for non-profits

Russell Investments Research

Mary Beth Lato, CFA, Director, Investment Strategy & Solutions

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 based on that return objective, assuming it has the risk tolerance to do so.

A common way to analyze 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 decision as to whether the organization is taking enough market risk in order 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 lead an organization to increase its allocation to equity 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. If 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.

Historical returns for the 10 years until December 31, 2019

If, on December 31, 2009, a client wanted to achieve an objective of CPI+4% with passive beta exposure, Russell Investments 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 organization would have earned a return of CPI+6.5%. That would be great news, and the return would be in line with the 69th percentile of the expectations from December 31, 2009.

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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 6/30/2020	9.7%	3.8%	8.8%	6.9%

Market returns were so strong that if one were to fast forward to March 31, 2020, after the extreme first quarter drawdown, the historical 10-year return would have still been closely in line with the original expectation. And the portfolio would have outperformed its CPI+ objective as actual inflation was lower than what was expected back in 2010. Equity markets then rebounded at an unprecedented pace and, by June 30, 2020, historical returns were once again well above previous expectations.

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Understanding return expectations December 31, 2019 through June 30, 2020

The bad news on December 31, 2019 would be that Russell Investments would have assessed equity market valuations and return expectations and determined that that the portfolio only has a 31% likelihood of achieving CPI+4% over the next 10 years. This change in expectation is due to the historical returns in the preceding period. As rising equity valuations fueled the equity market performance, we then account for the elevated valuations and have 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 that we would 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 unsaid is doing neither and just accepting a reduced likelihood of the organization achieving its objective in the future.

Now if we are to fast-forward three months to March 31, 2020, equity valuations were much more attractive given the recent declines in equity markets. The likelihood of achieving CPI+4% increased to 52%. Nothing changed in the portfolio construction, but due to the decline in equities, markets were now considered more attractive and it will be easier for organizations to achieve their objectives. However, an organization with an 80/20 portfolio would have just experienced a significant drawdown and may not find it reassuring that equities are now attractively valued. Thus, on June 30, 2020, after the market rebound, Russell Investments would estimate that a CPI+4% returns will be very difficult to achieve over the next 10 years. **Exhibit 2 demonstrates the extent to which forward-looking returns changed from December 31, 2019 to March 31, 2020; and then from March to June 30, 2020.**

Exhibit 2: Comparison of 10 year return median expectations[2] at 12/31/19, 3/31/20 and 6/30/20

	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%
6/30/2020	5.0%	1.6%	4.5%	2.5%

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

[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 of an organization to meet its goals given the current market environment. We recommend that organizations consider explicitly looking at how the investments assets have recently performed relative to the organizational objectives and account for that in the forward-looking analysis.

As of December 31, 2019, 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. **However, 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 based on future expectations or inclusive of historical returns and future expectations

	12/31/ 2019	3/31/ 2020	6/30/ 2020
Typical approach			
Likelihood of CPI+4% over next 10 years	31%	52%	37%
Alternate approach			
5-year historical return above CPI	5.8%	2.0%	5.0%
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%	3.5%
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%	41%

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 lead 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 historical and expected returns would lead to greater stability in the asset allocation process and 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 could lead to questioning whether we should just ignore market conditions in setting the strategic asset allocation. We believe market conditions should not be ignored, as it's important that investors are realistic about what can and should be expected in the future. However, incorporating history and future expectations will give organizations clarity as to 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.

This approach of incorporating both history 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 based on a smoothed market value of assets. This is likely to be the case for organizations that strictly follow policies that use a hybrid spending approach, percentage of assets based on smoothing over three to five years 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 have 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 you have a spending policy that quickly reacts to changes in the asset value (i.e., percentage of beginning of year assets) or if the official spending policy is only loosely followed with the ability 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 may not want to incorporate this approach at all as excess historical returns have already been spent (or have been budgeted to for spending), but others may find it useful for looking at objectives and 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 traditionally organizations have 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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