THE 2008 GLOBAL FINANCIAL CRISIS

Looking Back to Get Ahead

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Those who cannot remember the past are condemned to repeat it.
– *George Santayana, philosopher, essayist, poet and novelist*

Time helps you heal. It can also make you forget.

For instance, it may be hard for endowments and foundations, basking in the warmth of an extended economic expansion, to remember the havoc wreaked by the Global Financial Crisis ten years ago. They may be hard-pressed to recall the S&P 500's precipitous fall of nearly 40% in 2008 that decimated investment portfolios. Or the liquidity rout that forced many to sell performing assets at depressed valuations so they could meet their spending needs.

As those memories fade, institutional investors appear to be ratcheting up their risk in an effort to achieve their financial goals. Many have increased allocations to illiquid private market strategies and have cut back on more liquid, but lower-yielding fixed income. Further emboldening these investment moves is the prolonged and pronounced rally in U.S. equities.

At NEPC, we seek to use the ten year anniversary of the Financial Crisis as an opportunity to reflect on the past, evaluate the present and prepare for the future. In this paper, we will revisit the lessons learned that remain as relevant as ever today. These include: the value of disciplined rebalancing, the importance of understanding one's liquidity and spending needs, and the necessary integration of investment and operational functions. We hope investors take note of these insights to help safeguard portfolios against future economic downturns and market instability.

Don't just take our word for it: this paper also includes the perspectives of key decision-makers at endowments and foundations who were generous enough to share with NEPC their experiences and insights from the Financial Crisis.

#1 DISCIPLINED REBALANCING

It is imperative for those managing endowments and foundations to have a clearly established framework for their portfolios. At NEPC, we work with our clients to formalize and document an appropriate asset allocation and approach to rebalancing. This instills discipline regarding goals, including investment objectives, acceptable risk and asset allocation ranges. It also is the surest way to avoid a dangerous overreaction during a crisis.

"We didn't hold additional meetings or emergency meetings. Our action plan was written down in the policy statement and it was my job to execute," said Janet

Handley, (now retired) Vice President for Investments, the Texas A&M Foundation.

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>
> - Janet Handley
> Texas A&M Foundation

For three months in a row, in the thick of the Financial Crisis, the Texas A&M Foundation breached policy limits and had to sell other assets, such as Treasuries, to fund higher investments in equities. "I'm convinced if you try to make those decisions in the moment (of crisis), you will inevitably make the wrong decisions," said Handley. "It didn't matter if it felt good or not; we followed the blueprint of our policy."

This discipline mitigates the risks of emotional responses to a crisis and of market timing, while providing the flexibility to opportunistically pursue strategies. Not surprisingly, it is too late to establish an investment framework during a crisis. Portfolio rebalancing is an inexact science. And if there is a single aspect of investing that is susceptible to emotion, it is surely rebalancing.

Sticking to a strategy that was determined before times of stress and market turbulence is critical. The uncertainties and concerns around economic recovery in the aftermath of the Financial Crisis "made us more cautious at the time," said David Granat, CIO, the Robert R. McCormick Foundation. "But I don't think it changed how we wanted the portfolio allocated over the long term."

In a sense, rebalancing is less about taking a constructive step than avoiding a destructive one. Endowments and foundations put a great deal of thought into developing an asset allocation framework (and the broader determination of risk/reward tradeoffs appropriate for each institution). A moment of panic can quickly unravel that effort. By establishing a rebalancing framework well in advance of market turmoil, endowments and foundations can stay the course and steer clear of impulsive overreaction.

"You want to be careful – market timing is really difficult. The balancing act is to stay focused on the targets, not timing the market," said Granat. "We really try to manage our portfolio based on our target asset allocation. All we are doing is trimming back toward our targets."

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>
> - David Granat
> Robert R. McCormick Foundation

#2 UNDERSTANDING LIQUIDITY NEEDS

When the Global Financial Crisis hit, many endowments and foundations were overcommitted to illiquid strategies, including private equity, as the total market value of their portfolios tanked. Amid this liquidity constraint, many were faced with the challenge of meeting capital calls and were often forced to sell assets at depressed values.

In general, NEPC's clients were not overallocated to private market strategies, as we had carefully examined liquidity needs when pacing our clients' commitments. Indeed, some had dry powder to deploy at the precise moment when such flexibility was most valuable. Still, the Financial Crisis brought on a deeper level of introspection for many institutional investors.

> ***"This experience refocused our definition of liquidity and changed our thinking about how much liquidity we should have in our portfolio."***
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> - David Granat
> Robert R. McCormick Foundation

"We review liquidity and analyze risk in greater depth than before. We ask, 'How quickly could we get our money out if we needed to?'" said Joseph Winn, former chair of the investment committee and the former chairman of the Board of Babson College, a private business school located in a western suburb of Boston. "And we identify what the process would be to create that liquidity. We may never need to implement such a plan, but because of the exercise, we are much more aware of liquidity."

The Financial Crisis also compelled investors to revisit their very definition of liquidity as many so-called liquid investments were rendered effectively illiquid during market stress. At the time, cash and Treasuries proved to be the primary sources of liquidity, while even marketable equities and fixed-income securities could only find takers if they were marked down significantly lower.

"While we were fortunate to have ample liquidity at the time, this experience refocused our definition of liquidity and changed our thinking about how much liquidity we should have in our portfolio," said Robert R. McCormick Foundation's Granat.

"It also heightened our focus on the financial claims underlying the investments in our portfolio. Do we fully understand what's behind each of those claims? Which ones were direct claims or credit claims on the enterprises? Which ones were swap or derivative agreements? Do we own the equities directly, in a mutual fund, or in a trust? Let's make sure we understand what we own," said Granat. "It didn't change our view on owning directly or via a pooled vehicle, but underlined the need to do the proper diligence to understand what's in our portfolio."

A proper assessment of liquidity has two components: (a) an analysis of spending needs, and (b) an examination of investments to determine how readily they may be converted into cash, be it to meet spending needs or to rebalance the portfolio

Reassessing spending needs is often a painful but necessary endeavor. Unlike investment returns, which are inherently volatile and unpredictable, spending is one lever that can be controlled; this excludes private foundations, which have a 5% minimum spending requirement. Spending for university endowments has generally trended down over the past ten years, fluctuating from a high of 4.6% to a low of 4.2%, according to data from NACUBO.

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> Babson College

It is vital for endowments and foundations to strike an equilibrium between their short-term operating needs and long-term investment goals.

"It's always a balancing act," said Handley. The Texas A&M Foundation was created in 1953 to benefit the Texas A&M University, the second largest public university in the United States in terms of enrollment. The Foundation had a spending rate of around 6% in 2008, including 1% to cover fundraising and operations. It not only changed the measurement period from a three-year average to a five-year average, but also lowered the spending rate itself over several years down to 5%.

While analyzing the amount of funds required by an organization to meet future expenditures, there should be policies in place to prevent deviations from its long-term investment strategy by selling assets at a deep discount.

"We implemented a spending policy with a smoothing element," said Winn, referring to his time at Babson College. Historically, Babson drew heavily from its endowment to fund operations. The school reduced its draw percentage, which is tied to average balances over the past 12 quarters. "Those changes helped mitigate some of the volatility in spending and softened the ups and downs."

At NEPC, we work with our not-for-profit clients to understand the impact of spending on the operating budget during periods of market stress for both operations and investments through our Total Enterprise Management (TEM) analysis. This helps endowments and foundations better understand the impact of illiquidity and volatility of the investment program on operations and capital calls.

#3 INTEGRATING INVESTMENTS AND OPERATIONS

The best-run organizations ensure that operations, including long-term strategic decision-making, are tightly integrated with investments. This entails careful risk management to ensure that an organization is not doubling down on the same risk as it strives to balance its short-term needs and long-term goals.

To this end, we use our TEM model to integrate the short-term operating requirements of an endowment or foundation with the long-term objectives of the investment program to develop the appropriate asset allocation target. The higher the reliance on spending to support operations, the greater the need to stress test both the operating budget and the investment program under adverse environments.

"Babson now requires at least one joint meeting of the investment committee and finance committee per year. That enables us to fully integrate our planning for operations and investments."

- Joseph Winn
Babson College

Leading up to the Financial Crisis, few organizations performed an integrated risk assessment across both operations and investments. For instance, Babson College, like many institutions, historically separated the strategic planning process from the investment practice. While this approach can efficiently divvy up labor, it leaves endowments and foundations susceptible to blind spots as those tasked with making decisions around investment risk may not be aware of other risks facing the organization.

"We have made a number of important

changes from a governance perspective," said Winn. Babson now requires "at least one joint meeting of the investment committee and finance committee per year. That enables us to fully integrate our planning for operations and investments."

While the two factions had some overlap—roughly one-third of its investment committee members also served on its finance committee—the move to formally hold a joint meeting of these two groups "has been very productive," said Winn.

We believe the integration of the investment program with the broader strategic aims of the organization can only lead to positive outcomes. Since the purpose of the assets is to support the mission of the organization, decoupling investments from the organization can often lead to a misalignment of interests between stakeholders. Success in investing is not simply an absolute return from investments, but also aligning the investment portfolio with the organization and its mission.

IN CONCLUSION

As the Global Financial Crisis retreats in the rear-view mirror, complacency can take hold. While this is only natural, the inevitability of another crisis is just as natural.

"How long do you go on with this moderate economic growth and still get the kind of equity performance we've been getting?" said Granat at the Robert R. McCormick Foundation. "That kind of dilemma has not gone away."

Still, adversity is not all bad. It can fuel self-reflection that can promote efficiency and greater self-reliance. While timing and causes of the next economic downturn can be difficult to predict, we can take to heart the lessons learned.

"Our biggest concern about the Financial Crisis was that the investment performance of the endowment could hurt (Babson)," said Winn. "I'm not sure that concern ever fully goes away, but we feel we are in much better shape today."

At NEPC, we urge organizations to secure their liquidity position, exercise discipline around rebalancing to target weights, and consider both the investment and operational risks facing the organization.

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Vice President for Investments (retired)
Texas A&M Foundation
Texas A&M University is a coeducational public research university in College Station, Texas. It is the second largest public university in the United States in terms of enrollment. The Foundation was created in 1953 and exists for the benefit of Texas A&M University, serving as the university's primary academic fundraising institution.

David Granat
Chief Investment Officer
Robert R. McCormick Foundation
The Robert R. McCormick Foundation is one of Chicago's leading philanthropic organizations. Its mission is to foster communities of educated, informed and engaged citizens.

Joseph Winn
Former Chair of the Investment Committee and Former Chairman of the Board
Babson College
Babson College is a private business school in Wellesley, Massachusetts, established in 1919. Its central focus is on entrepreneurship education, and it is often ranked the most prestigious entrepreneurship college in the United States

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