INSIGHTS 01.06.22

Nonprofit News Special Report: 2022 Traditional Investments Outlook

Many nonprofit investors anticipate positive but muted returns from the equity and bond markets in 2022 and are looking to de-risk their portfolios and rebalance toward policy allocations after colleges and universities saw their highest returns in more than three decades.

The prospects of economic and societal impacts of new COVID-19 variants coupled with continued supply chain issues and an inflationary environment that is less transitory than initially expected has led investors to take a more cautious approach with their investment portfolios.

"I think that there's a flattening that is going to happen. There should be some pull back too, and I think we're seeing a little bit of that already. Looking at the broad markers on benchmarks and indexes like the **Standard & Poor's** 500, it is good to see them all not green all the time. We want to see that mix of red and yellow because that is what the markets should be doing," said **Phong** '**Tony**' **Vu**, treasurer, cio and associate v.p. for budget and finance at the **University of Colorado**.

He finds that the markets have "taken a lot of the returns from the future and just brought them here to the now," and wonders how much of the returns have been fast tracked.

"Do I see catastrophe and all bad things ahead? Absolutely not. I'm happy that the markets are somewhat decoupling again, and a little different from the GFC [Great Financial Crisis] where everything was red and you couldn't save yourself there," he added.

Greg Dowling

FEG Investment Advisors CIO and Head of Research **Greg Dowling** pegs the Cincinnati, Ohio-based consulting firm's return assumptions as modest, yet positive for the next 12 months**.**

"Equities are pretty overvalued from a historical perspective, but factoring in the low interest rate environment, they are probably fairly valued. You're not going to get much in the way of multiple expansion likely, you might even get some multiple contraction, so it's really going to depend on earnings. In the U.S., at least, earnings have been pretty strong," he said. "I think what we're going to need to watch is really how we get through the winter and the holiday season and see if there are any more variants that creep up. If not, come spring, we could be setting ourselves up for pretty good returns, and unintentionally, kind of ex-U.S. returns as the rest of the world plays catch up with the U.S."

It seems an insurmountable task for nonprofit institutions to generate similar returns in 2022 as they did in 2021 as large colleges and universities with assets greater than $500 million generated a median return of 33.2% in fiscal year 2021, the highest since 1986, while smaller colleges and universities generated a median return of 25.1%, according to the **Wilshire** Trust Universe Comparison Service.

Some of the nation's top 2021 performers include **Washington University of St. Louis**, which returned 65% last year to grow its endowment to $15.3 billion, while **Bowdoin College** generated a 57.4% return and **DUMAC**, the investment management arm of **Duke University**, reported a 55.9% return in the last fiscal year, according to data compiled by **FIN Searches.**

At the same time, institutions that performed closer to the median were nothing to scoff at, with the **University of California** growing its assets under management by $38 billion to $168 billion, the largest one-year gain in its history. The institution's more than $19 billion endowment returned 33.7%, while its $91 billion retirement plan returned 30.5% to help it achieve the record gain.

In ringing in the new year, the S&P 500 Index returned 26.89% by way of 68 record highs in 2021, while the **MSCI** ACWI Index returned 16.8.%, the MSCI Emerging Markets Index returned -4.59% and the **Bloomberg Barclays** U.S. Aggregate Bond Index returned -1.54%, according to data reported by **Morningstar**, MSCI and Bloomberg.

Despite robust 2021 performance and some optimism for 2022, investors and allocators have concerns regarding the lasting impact of the pandemic, slower economic growth and uncertainty surrounding earnings due to factors that include wealth redistribution policies and climate policies, which leave expectations on their equity performance waning.

"Our ten-year expectations for the S&P are closer to about five and a half. I think that we're going to be below the long-term average [over the next 12 to 18 months]," said **Mary Jane Bobyock**, managing director of the nonprofit advisory team at **SEI Investments**. "We're not going to see double digit-type returns, but we think that we'll still see positive returns and one of the reasons that we like equities still is because they're able to absorb any inflationary impact and that's a big wildcard right now. We see continued growth in the economy. As we see more pressure to increase interest rates, that's going to have more of a detrimental effect on fixed-income."

The broad sentiment for modest positive equity returns in 2022 is in line with **J.P. Morgan Asset Management**'s capital market assumptions, which peg domestic large-cap equity compound returns at 4.1%, in line with their 2021 forecast. Those returns trail projections for domestic mid-cap at 4.3% and domestic small-cap at 4.4%, according to the firm's 2022 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%, Euro-area large-cap equity at 7.1%, emerging markets equity at 6.9%, all country Asia ex-Japan equity at 7% and Chinese domestic equity at 8.2%, according to its 2022 outlook report.

"In general, today, our equity returns are lower than they have been over the last couple of years and that's largely because of the way we have thought through valuations as equity markets continue to creep up. Valuations get a little more frothy and then therefore we expect the valuations to compress over time," said **Kristin Reynolds**, partner and head of **NEPC**'s endowment and foundation practice. "The expected return for equity markets in general is not what we've seen in the past, certainly lower, but relative to fixed-income markets, we still see a pretty strong equity risk premium."

U.S. Equity To Help Achieve Spending Plus Inflation Targets Amidst Inflation, Volatility

NEPC is recommending that clients maintain their full weight in equity markets, with a slight overweight to U.S. equity because of their view of a strong equity risk premium and excess liquidity in the markets, according to Reynolds.

Kristin Reynolds

"Higher inflation prints are going to spook market volatility, but over longer periods of time, inflation can be good for equity markets," she said. "Despite where we are in valuations, I think people are cognizant of the fact that there's still a lot of liquidity in the system, that they can withstand the volatility that they see in public equity markets and definitely continued their tilt towards public equity versus lower volatility asset classes."

SEI carries a positive sentiment on the U.S. equity markets in the near term because of potential firepower waiting to further boost the economy.

"The pandemic affected certain industries more than others and the Fed really stepped up to help, along with fiscal stimulus, to keep everybody afloat. In general, households are in excellent shape right now. They've paid down debt throughout the pandemic … There's a

excess in the system of around $2 trillion in savings. So, as people start to leverage back up and spend, there's a lot more firepower there available to the economy, which could be a positive. Now the travel industry and some restaurants and things like that, they are still recovering, but there's more enticement to get the labor market moving again. I think that we're over the hump in that regard. Looking at it with the pandemic now, I'm optimistic that it's a better scenario than it was in March of 2020 when we didn't know anything," SEI's Bobyock said.

BMO Capital Markets Chief Investment Strategist **Brian Belski** finds that double-digit earnings growth, declining valuations, still excessively low interest rates and eventually subdued inflation present a "very good backdrop for equities."

"Remember, equities are traditionally the best inflation hedge – and, yes, stocks can, will, and should go up alongside interest rates – after all, rising bond yields means the economy is improving – which the stock market has already been telling us thanks to its powerful rally in the past few years in both the United States and Canada," he said, in his 2022 North American market outlook.

Brian Belski

With that sentiment, BMO is advising clients to overweight "financials, discretionary, industrials and materials, while equal weighting both growth and value, let alone small, mid and large cap stocks" over the next 12-18 months, according to Belski.

He noted that clients should differentiate their positions by increasing their focus on quality, growth-at-a-reasonable-price and dividend growth across all size, styles and sectors.

While the firm continues to believe the U.S. is in a 20- to 25-year bull market, it finds that the next three- to five-years will have “more normalized” returns in the high single to low double digits in both the U.S. and Canada.

“To be clear, society had been nothing less than tumultuous the past few years,” he said. “However, equity markets around the world and investing in general have been very exciting to say the least, but as markets, let alone society itself begins to normalize and moderate over the next few years as the great unwind of the COVID19 pandemic ensues, we continue to focus on the positive – because after all, positive is still positive.”

FEG Head of Institutional Investments **Nolan Bean** finds that while investor attention has been on mega-cap technology stocks like **Alphabet**, **Amazon**, **Apple**, **Meta** and **Nvidia**, longer-term secular opportunities are presenting themselves in biotechnology.

“I think there’s some room there where the investor community writ large is a little bit under invested in biotech,” he said. “Tech has been the big winner and that’s really driving markets with some of the mega cap names. That’s a phenomenon last year that was just amazing with just a handful of stocks really driving the index returns, so having to be a little bit more mindful of just how far some of those mega-cap names have run and looking for a little bit broader exposure in tech versus just loading up on a handful of stocks that are trillion dollar market caps.”

FEG is bullish on biotechnology and continues to recommend investments in the space due to a bevy of tailwinds.

“The innovation from the scientific community is just amazing. As an example, the vaccine that **Moderna** created, that had it in five days. From there it was just proof of efficacy, going through the phases of testing and then building out distribution. So, it’s really phenomenal and I think that has a longer-term trend of science is getting better, cheaper, faster. Big pharma is needing to acquire more things for their pipeline, and a lot of that is coming from the innovation of some smaller stocks. The FDA continues to be fairly supportive,” Bean said.

Growth Versus Value Debate Continues As 2021 Shaped By Large Versus Small Stocks

The largest U.S. companies outperformed their small-cap counterparts by more than 10% in 2021 as the net return for the Morningstar US Large Cap index was 26.67% compared to the Morningstar US Small Cap index's 15.85% , according to **Morningstar**'s indexes.

The outperformance was not the case throughout the entire year as small-cap companies started off 2021 strong due to optimism about the reopening of businesses and the impact on the economy as well as broad availability of COVID-19 vaccines. Large-cap companies surged ahead in the second half of the year behind a backdrop of supply chain disruptions, inflation pressures and new coronavirus variants prompting some investors to take a more risk-off approach with less volatile stocks.

Investors will shift their portfolios toward or away from large- and small-cap stocks based on sentiments of what lies ahead amid a backdrop of concerns about COVID-19 variants, market volatility and supply chain disruptions, leaving the growth versus value debate ongoing.

"Value and growth have both taken their turns as the leader. Right now, value is actually quietly doing pretty well as some of the growth names are taking it on the chin," said FEG's Dowling. "[Moving forward] It really depends on whether you have the restart 2.0 or the work from home trade. You are going to have to kind of keep your eyes on what variants pop up and how vaccine rates go through. There are probably components of both that will probably do well, probably quality growth. So, you're seeing some of the junkier growth names get pretty beat up, so think of some of the arc names per se versus some of the Microsoft's and Apples of the world. Those are probably more quality, so quality probably does pretty well. And then maybe components of value do well. Value, especially small-caps, tend to do fairly well if we add inflation and that would really be driven by cyclicals, energy and financials. If we do have some inflation, you could see some returns through value through small cap."

Vanguard Group Global Chief Economist **Joe Davis**, who also serves as global head of the firm's Strategy Group, has a favorable outlook for value stocks despite the fact that the value premium has not been realized on average over the past 20 years, including U.S. growth stocks outperforming U.S. value stocks by 7.8% per year over the last 10 years, according to research from the firm.

"Some are actually challenging the value premium itself, perhaps because recent performance has not supported the value premium as well as some arguing that growth companies actually may not be as overvalued as you think when you account for things s as intangibles, brand equity, scale effects, things that you would characterize consistent w

technology transformation some of which may not be captured in accounting statistics," Davis said, in an interview with **Mason Investment Advisory Services** Director of Research **Tom Pudner**.

Davis' Chief of Staff **Ian Kresnak** expects value stocks to generate positive long-term returns to the tune of 9% annualized returns over the next five years.

"Even when we account for intangibles and their impact on balance sheet by looking at the security level in balance sheet intangibles and rolling that up, growth relative to the broad market is still overvalued," Kresnak said. "It certainly helps explain some of it relative to the broad market, but not all of it and that's really what gives us a little bit incrementally more conviction in this outlook."

SEI's Bobyock finds that investors should continue to be diversified across growth and value moving forward, mentioning that value stocks may also receive an uptick from the profits and earnings of growth and technology companies that have led investment returns in recent years.

"We should see some normalization in terms of P/E multiples, but some multiples should attract more than others, especially for high price growth and technology," she said. "So, we do think that we could see that come around and that value-oriented stocks will benefit from their profits. For example, banks' balance sheets are in really good shape right now and they're a driving force in value. So, we think there is more advancement available in the value side."

John Alexander, cio of the approximately $1 billion **Clemson University Foundation**, has a more favorable outlook for growth versus value over the near term despite not trading deliberately on the virus and potential variants as he is expecting margin contractions.

John Alexander

"Growth looks better than value during a virus. There is no reason to think that the same thing that works well during the first wave of the virus won't work well during the second wave of the virus … In my mind, I'm glad banks are doing well and they are changing their payment systems and I'm glad healthcare is doing well and there are some changes there, but there's really not going to be any disruptions in the value space as a percentage as there will be disruption in the growth space," he said.

Alexander mentioned the seasonality of large-cap value outperforming large-cap growth in the first half of the year, and while large-cap value is supposed to be doing well in the first half of the year, he expects the tides to turn in favor of large-cap growth.

"I just think in 2022 large-cap growth is still going to be the place to be just because of the potential for significant disruption and when I say disruption, [I mean] significant impactful things going on at the company level. I think there will be more significant impactful things going on in growth than there will be significant impactful things going on in value," he said.

While the growth versus value debate continues to have legs, NEPC's Reynolds finds that now is an opportune time for nonprofits to rebalance back to their target weights for each style.

"We have definitely let growthier managers run for the last couple of years … As we got through the third quarter of last year, really what we saw was the growthier manager valuations continue to expand and so for risk management purposes, we've really been talking to clients about balancing some of their growthier managers by redistributing or

rebalancing back to some of their value managers. It's not that we have an outlook for value managers to outperform, but more of a risk management to rebalance portfolios to include more of the value in their portfolios," she said.

Cautious Approach May Be Prudent In Face Of Slowing Economic Momentum

The Clemson University Foundation is a strategic index allocator as it has more than 60% of its portfolio in publicly traded indices, mutual funds and ETFs, and with such a large portion in public investments, Alexander regularly reviews the Shiller PE Ratio, a ten-year inflation adjusted cap-earnings ratio, to measure the market's valuation.

The current ratio is 40 while the average ratio for the last three decades is 25, and Alexander finds that current valuations are not sustainable, leaving him expecting margin contraction globally. He noted that while he is not trading deliberately on the virus and potential variants, all of the things he would have done during the first wave of the virus coincide with things he would do during margin contractions.

"That is causing us to be very careful of where we are putting our equity dollars. Our allocation within the equity space are geared more to a risk-off trade. And when I say risk-off trade, I mean larger capitalization, more domestic. If we talked probably eight months ago, I would have said, 'well, international is looking interesting but it's looking less interesting to me in 2022.' Risk-off in non-U.S. equity means heading more toward developed rather than emerging," he said.

While he has moved the South Carolina-based foundation's portfolio toward the risk-off approach, he still expects investors to remain in the equity markets.

"Even if the Shiller PE falls to 25, the historical norm, that is going to give you a 4% earnings yield and the 2% inflation that's going to give you a 6% nominal yield. If you think about the 10-year yield of 3% to 3.5%, which 1% to 1.5% over the Fed funds rate, you're still going to have an equity risk premium of 2.5% to 3% and I think an equity risk premium there is above nominal risk-free rate to keep people in the equity markets," he said.

Amundi Asset Management's 2022 Investment Outlook finds that real rates will determine the fate of excessive equity valuations and when they "eventually pick up," it will challenge the bubble areas in the growth space, prompting the firm to recommend selection based on "earnings and pricing power, quality and value, amid higher costs and rising rates."

Phong 'Tony' Vu

Colorado's Vu is concerned with the public markets as he questions consumerism's ability to fuel economic growth.

"I think the 'haves' economy can continue and be sustained. That's the nature of having, you can live through these ups and downs. I don't know how much longer the 'have not' economy Is going to sustain the consumer spending that needs to happen in order to support that. On the other side, it's not just a country-by-country basis anymore. It is truly global. You don't have to depend on just the United States consumers and you can spread that out, plus you have more of a service economy that sort of feeds globalism … However, those financial contagions and viral contagions are global and reflected in the markets, which I worry about the most," he said.

Amundi expects that equity markets will remain vulnerable to minor pullbacks in the near term "as higher inflation, decelerating growth and weak data provide less ground for complacency."

The Paris-based firm also finds that a "less benign environment for risky assets" could lead to markets overreacting to Central Bank actions and challenging the credibility of monetary policies, which would result in risk asset valuations repricing.

Interest Remains In International, Emerging Markets Due To Valuations, Growth Opportunities

Russell Investments' cycle, value, and sentiment investment decision-making process scores global equities as expensive, with the U.S. as the most expensive developed equity market globally and the U.K. as the best value.

The Seattle-based consulting firm prefers non-U.S. equities to U.S. equities as "above-trend global growth and steeper yield curves should favor undervalued cyclical value stocks over expensive technology and growth stocks," said **Andrew Pease**, global head of investment strategy, in the firm's 2022 annual market outlook. "Relative to the U.S., the rest of the world is overweight cyclical value stocks."

Amundi also carries a favorable sentiment toward Europe due to the NextGenerationEU economic recovery package and its focus on the transition to a green economy.

SEI expects above average growth globally and holds a positive view for Europe in addition to the U.S.

Mary Jane Bobyock

"U.S. has been, and we expect them to still be, the growth leader. Europe might be off to a bit of a rocky start because of the current shutdown, but we expect that eventually they'll be fully supported by more fiscal and monetary stimulus," Bobyock said. "They won't see as much tightening for example, as we might see in the U.S., so they're a little bit behind us in that cycle, which means that there is still more opportunity there for growth. Back to last year international did very well, but the strength of the dollar was a bit of a surprise, so that

offset the impact for U.S. investors. From an equity perspective, we still like the U.S. but we also are still liking international developed and in the emerging space China is the biggest wildcard there."

In addition to its recommendation to maintain a slight overweight to domestic equity, NEPC is recommending clients maintain a slight overweight to emerging markets versus EAFE markets "largely because the emerging markets continuing to be a growth area relative to the rest of the world," according to Reynolds.

NEPC's 10-year return assumptions as of Sept. 30, 2021 pegs emerging markets equity at 8.1% compared to 5.8% for global equity and 5.4% for non-U.S. developed markets equity.

Amundi is also favoring emerging markets due to valuations and institutions' allocations likely being below than their strategic targets, according to its outlook research, which notes that a country-by-country assessment "will be key when looking at EM opportunities in the context of China's policies, price evolution and fiscal and monetary room."

SEI finds that China is a "wildcard" for emerging market investments because of its lack of stimulus and more importantly its "real estate and technology crackdown," however, the Oaks. Pa.-based firm expects the situation to improve.

"We do expect their grip to ease eventually because they have so many of their citizens, half of the Chinese population owns real estate, including investment oriented real estate, so they really want to try to thwart a real estate crisis there," Bobyock said. "They've had a drop in spending, so hopefully we'll see that turn around, which would help emerging markets as well."

FEG's Dowling sees additional return from the international equity space coming toward the second half of next year as countries improve vaccination rates and lockdowns subside and/or improve. At the same time, China will be a focus because of the role it plays as the world's second largest economy.

"International and emerging valuations are lower … but they are not the lowest we've ever seen. I think the biggest question mark is China. China's the biggest exposure geographically for the emerging market index and we're not sure where China's going. It seems like they're pulling inward and being a little bit more aggressive both politically and militarily. But at the same time, it's really hard to not invest in the second largest economy in the world and sc to be the first," he said.

FEG's view is to "choose the lesser of the evils" and focus on the China A-Shares market.

"You focus on more domestically oriented opportunities that are important to China and the Chinese government. You probably don't want to invest in a global chip maker that has its business plan to sell in the U.S. because it's not going to be allowed. But, sort of the basic businesses, maybe even traditional boring businesses, there's a lot of them out there that serve the needs of the people and that's a really inefficient market, so there's a great opportunity there for stock pickers. You can't avoid it totally, you just have to be smart about your allocations," Dowling said.

Investment consultant **Cambridge Associates** expects China onshore A-shares to outperform global equities in 2022 as the investments are inexpensive relative to global equities and are relatively insulated from the regulatory stresses that have disproportionately hit the offshore market, according to the firm's 2022 outlook, which notes that the A-share market is underweight tech, particularly the consumer discretionary and communication services sectors that include stocks like **Alibaba**, **JD.com**, **Meituan** and **Tencent.**

Reynolds finds that while many endowment and foundation clients have exposure in their portfolios above or commensurate with China's market weight, which is growing, however, "It's difficult to pull the trigger on building to that market weight," she said, noting that "there are opportunities across the country that might be interesting for indexing for long-term investors."

"There is a large push back based on near term pressures between China and the U.S. and so, I think, over the coming year we will talk about building towards market weight exposures in China," she added. "What we've been most interested in is Chinese private markets as they have some very interesting trends in healthcare and other sectors that we might take advantage of first."

Nolan Bean

For investors and allocators that may have difficulty deciding which markets present the best investment opportunities and suit their portfolios' needs, FEG's Bean suggests incorporating a global equity mandate.

"There has been a lot of volatility and dispersion and some of the fundamentals aren't strong outside of the U.S. … rather than allocate or having to make a top down choice am I over or underweighting China or Europe, finding global managers with a global perspective that can make some decisions from a bottom up company-by-company basis is a way to hopefully be more refined in your exposure," he said.

Reynolds expressed a similar sentiment for allocators that are expecting more volatility and near-term declines.

"I think we've been really focused on where we can get the most value out of active managers … which is small-caps, especially international small-cap and emerging markets as well. We also see a lot of good managers in the global equity space and those are the managers that can cover U.S., non-U.S. and emerging large-cap and small-cap so we still direct a large portion of the public equity portfolios to global equity active managers."

Fixed-Income: More Questions Than Opportunities

Nonprofits may not have a significant portion of their portfolios in fixed-income, but the majority of the Federal Open Market Committee members' projections that there will be three interest rate hikes in 2022 leaves investors with more questions than answers about

what to expect from their fixed-income allocations in the short term.

Investor expectations are not particularly high in the near term as the University of Colorado's Vu said institutions are hoping for a 1% return and "hopefully not a loss."

"It's certainly not going to help much by way of achieving that 8% or so return, which I would be happy with 5% or 5.5% over the next 10 years," he said.

Twelve Federal Open Market Committee members anticipate at least three rate raises next year, while five members expect two rate hikes and one member awaits a single hike in 2022, which does not bode well for concerns about rising inflation. Allocators, however, remain confident in the Fed's guidance.

"I know inflation will not get too far out of hand. All of the central banks will fight that," Vu said. "The first arrow out of that quiver was to try to tamp down expectations for inflation. Whether they believed it or not, saying this is transitory was setting the expectation that this is not going to last. As soon as people thought it was going to last, they had other tools to try and ratchet that down. I think they have all the experience and I think they think they have all the data that tells them what they need to do."

The FOMC's indications of interest rate increases will likely follow its decision to reduce the monthly pace of its net asset purchases by $20 billion for Treasury securities and $10 billion for agency mortgage-backed securities. The FOMC will increase its holdings of Treasury securities by at least $40 billion per month and of agency mortgage-backed securities by at least $20 billion per month beginning in January, according to a FOMC statement following its Dec. 15 meeting.

"Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation. Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses," the statement reads.

"We were definitely in the camp that inflation was transitory, but there are certainly parts of it that are stickier," NEPC's Reynolds said. "Our expectations for inflation are over a 10-year period and they have crept up a bit for a 10-year period, but we're absolutely focused on that being mitigated over the later years. We're certainly seeing some higher inflation prints in the earlier years, and some of it is still transitory, but other parts of it are stickier. We don't thi
the inflation prints we've been seeing more recently are here to stay for long periods of tin

Inflation drivers such as backlogs and supply pressures have improved, but it is starting to show up in "stickier categories" like rising shelter costs, which includes rents, according to **Ritchie Tuazon**, principal investment officer of **American Funds**' Strategic Bond Fund, in its 2022 fixed-income outlook.

With the prospects of continued inflation and higher interest rates, areas associated with higher return outcomes like high-yield and bank loan investments may be attractive for investors trying to reach their spending targets. At the same time, slowing growth and the notion of Treasuries as a safe haven will continue to play a role in nonprofit portfolios.

J.P. Morgan's compound return assumptions for U.S. Long Treasuries have increased to 1.8% in 2022 from 0.4% in 2021 and 1.6% in 2020, while projections for U.S. Aggregate bonds are 2.4%, according to the firm's 2022 return assumptions. Leading the firm's assumptions domestically are leveraged loans and high-yield bonds with compound returns of 4.7% and 3.9%, respectively. In looking internationally, emerging market local currency debt and emerging market sovereign debt are pegged highest across strategies with compound returns of 5.9% and 5.2%, respectively.

SEI's Bobyock pushed back on the negative sentiments surrounding the asset class's performance as investors anticipate the end of the multi-decade bull market in bonds.

"I go back to the notion that investment grade fixed-income is there for return seeking purposes. You don't want it to be a detriment on your return, but in general, even the rising interest rates don't necessarily mean horribly poor performance for fixed-income," she said "We don't expect to see large giant swings in rates increasing quickly, but the Fed has been very proactive about taking baby steps and being very transparent, to help the market not overreact and have a taper tantrum or whatever. So that's a good thing from helping to manage the reaction of bonds."

She added that there is still a long-term place in the portfolio for fixed-income as part of a well-balanced asset allocation in the 10% to 20% range "if nothing else for just clipping the coupon."

Fixed-Income Allocations Remain Small, Serve As Ballast

Amid the anticipated positive, yet muted, equity markets, Clemson's fixed-income allocation remains at its minimum allocation of 10% so the remainder of the portfolio can be used t achieve its investment objective, according to Alexander.

The portfolio looks to attain an average annual real total return, net of investment management fees, of at least 5.25% over time to provide spending support to the university and maintain an individual endowment's purchasing power over time, according to its investment policy.

The foundation's portfolio includes one active core-plus manager with the remaining investments indexed between long-term, short-term and cash, according to Alexander.

"We don't stray outside of where basically the Barclays Agg is our benchmark … I'm not a fan of owning something that might represent less than 2% of the portfolio and occupy 30% of my time," he said.

The average fixed-income allocation of all public colleges and universities in fiscal year 2020 was 14%, while the average for all private colleges and universities was 12%, according to the 2020 NACUBO-TIAA Study of Endowments. Endowments over $1 billion allocated the least to fixed-income, 11%, followed by institutions with between $501 million to $1 billion in assets at 15%, while smaller institutions between $101 million to $250 million allocated 20% and endowments under $25 million allocated 31% to the asset class, the study showed.

Bobyock finds that institutions should maintain their smaller allocations to fixed-income as they will continue to play a role as ballast in the event of a downturn or as liquidity in a dislocation.

Keith Berlin

"We always look at investment grade fixed-income … as a very cost-efficient anchor. So, if there is a flight to quality, that is one of the few asset classes that will actually or should present positive returns. So, we do think that having a small allocation to investment-grade fixed-income still makes sense, especially from the budget perspective."

Keith Berlin, senior v.p. and director of global fixed-income and credit at FEG, carries a similar sentiment finding that fixed-income is crucial when it comes time to fund other riskier investments.

"I think on the rate side with the traditional allocations, there still needs to be a focus on having a store of value if for no other reason than to fund your private investments," he said. "We need to do our best to not lose money. We have to invest in the environment that we are in, so we are going to be cautious there while that makes sense."

Duration Risk & Yield Curve Leaves Investors Eyeing Bank Loans, TIPS

Putnam Investments finds that rate-hike expectations may stay elevated until the end of the first quarter of 2022 and a rise in 10-year U.S. Treasury yields or other longer-dated risk-free bonds will be contained, which would likely benefit many risk assets, according to a recent perspective piece from the Boston-based manager.

The firm also finds that a rise in longer-duration bond yields, whether from balance sheet reductions or other means, could lead to high volatility for risky assets and attempts to steepen the yield curve or raise real rates are likely to trigger a repricing of financial assets with volatility occurring as soon as the balance sheet discussion starts, likely toward the end of March or early April.

FEG's Berlin also finds that as the Fed turns more hawkish on policy, the yield curve could flatten or invert.

"There's a reasonable chance we see an inverted yield curve at some point in the next 12- to 18-months. It's hard to know how things progress. You could see the Fed struggle raising rates and then the longer end of the curve starts to come down even further or stay here at these levels just because of the anticipation for lower growth going forward…It's going to be a challenging environment to navigate this to avoid overdoing it with rate hikes and potentially moving us towards a recessionary environment, so we've continued to suggest investors remain a shorter duration type of profile." Berlin said.

It is clear to Alexander that investors should reduce their exposure to fixed-income and shorten their duration to the assets in the rising rate environment, which can be accomplished in a number of ways.

“You can go from long-term fixed-income exposure to mid-term or short-term fixed-income exposure or you can even take your long-term and move a portion of that in cash to shorten the duration because ultimately cash is a zero duration Treasury. When I talk to my students about Treasuries, I hold up a dollar bill and say there’s only one thing that has a shorter maturity than a T-Bill, cash,” he said.

Berlin suggests investors maintain a duration profile of four to five years to avoid rate risk.

“We’re looking at consumer-related credit and bank loans, which are corporate credit, that have a shorter duration profile that would do well if rates do ultimately rise on the short end and sort of out yield the kind of intermediate to Barclays Aggregate type of return profile. So, we’re trying to not have much rate risk. We don’t really know where rates are going go. It’s always hard to make that decision so we think kind of playing it safe for a year without having much rate risk is the way to go on the traditional side,” he said.

Amundi urges investors and allocators to “resist the temptation to go long duration after the first leg of rising nominal yields” as curve movements, currencies and cross-regional opportunities will flourish in a world of divergent monetary policies. The firm finds “unconstrained fixed income will remain the name of the game” as managers are not required to adhere to specific bond ratings, currencies or sectors.

Ritchie Tuazon

Bonds of varying maturities experience different effects from rate increases and the Bloomberg U.S. Aggregate Index, which features a mix of high-quality issues across sectors and maturities, has only had a negative return once over the last four periods of hikes while the average return over those periods was 3%, according to **Capital Group**'s 2022 outlook.

"Actively managed bond funds can position portfolios to focus on certain parts of the yield curve. We can avoid bonds that we believe will be more adversely affected by rising rates. We can also aim to mitigate inflation risk by purchasing Treasury Inflation-Protected Securities," Tuazon said.

TIPS are linked to the Consumer Price Index, so they have the potential to outpace nominal Treasuries in periods of rising inflation, according to the outlook.

T. Rowe Price Associates anticipates that TIPS "likely perform relatively well in an inflation-driven sell-off in risk assets such as equities," according to a recent white paper from the firm, which finds that shorter-term TIPS would be the most effective hedge against inflation risk, while longer-maturity TIPS, with their higher interest rate risk, are typically a better fit for hedging against a drop in risk assets.

"Because nominal Treasuries have also tended to benefit from their 'safe-haven' status in periods of intense market risk aversion and deflationary environments, exposure to a combination of TIPS and nominal Treasuries should likely be a key component of an overall portfolio allocation, in our view," the paper states.

Bank loans are an attractive investment for nonprofits in the current environment as CLO issuance closed 2021 at a record high with demand for floating rate, income-producing investments allowing borrowers to push out maturities and strengthen balance sheets, according to **Newfleet Asset Management**'s 2022 Bank Loan Market Outlook. The report also noted that open capital markets allowed companies to raise record amounts of loans, $621 billion by mid-November, for M&A, LBOs and other opportunistic uses including dividends.

The firm expects issuance to fall short of 2021 levels due to a lack of near-term maturities as well as a potentially slow start as the market continues to transition to Secured Overnight Financing Rate-based loans, however, loan issuance should remain healthy due to continued investor demand for low duration, income-producing opportunities.

"We anticipate a coupon-clip return profile. The macroeconomic backdrop remains favorable, and the technical picture is healthy, but current valuations now make this a credit-picker's market because several current challenges may create idiosyncratic results among borrowers," said **Frank Ossino**, sector manager of bank loans, in the report. "Still, we remain constructive on the asset class as investors weigh the impact a rising rate environment might have on fixed rate portfolios. All this as we enter a major change in the loan market – the transition from LIBOR- to SOFR-based loans."

Newfleet points out a couple of concerns with the strategy including initial volatility around LIBOR/ SOFR relative value, pricing and the impact on demand as well as a less accommodative Fed and eventual return to on-trend or lower growth possibly resulting in today's incremental borrower becoming the inventory of future distress and defaults.

High-Yield, Credit Space Present Opportunities

With traditional fixed-income investments unable to provide enough yield to help institutions reach spending plus inflation targets, some investors may look at high-yield strategies as default rates remain subdued.

Berlin finds that high-yield coupons are around 5.6%, which is "not too bad plus or minus a little bit on the price side" as long as there is not a large spread widening event in the next year.

"But the yield is a bit lower than that, so what's interesting is private debt, particularly lending is where investors can do better on an absolute and relative basis. We're looking at a risk premium of more than 600 basis points between mezzanine debt for example versus high-yield bonds and usually there's a good risk premium between the two," he said.

Allocators and investors that are able to identify good lenders they are comfortable with keeps the space attractive, according to Berlin, who noted that "when the Fed came in [during] 2020 and said they would support the high-yield market, that really brought spreads back in fairly quickly and it's sort of a self-fulfilling prophecy here as spreads come in, prices improve, default rates and default risk goes away."

Bobyock sees high-yield as an area of opportunity for nonprofits, just not in their fixed-income allocations.

"High-yield is another derivative, if you will, of fixed income – it's a little bit of a blend of equity and fixed-income. It does have expected returns more comparable to equities, but with long-term volatility, maybe 25% to 35% less. So, we still think that there is a strategic place for high-yield, but maybe it's more in the return enhancing bucket as opposed to the risk reduction basket. And when we think about asset allocation, we tend to think of it more in terms of the functionality of the asset classes and not just straight equities, fixed, other types of breakdown," she said.

At the same time, investors need to be able to stress test their portfolio for credit sensitivity, Bobyock said.

"Most of our clients have been in high-yield for a long time. We think it's very much a strategic place to be. In general, we think that corporate profits and balance sheets are also stronger, much like U.S. households, so that's a plus for the credit markets. It's also a return diversifier, so if there is a rebalancing to occur, you don't want to have too much in equity depending on your ability to weather a downturn. High-yield is a little bit safer place to be then equities over the long term, but clearly not as safe as investment grade fixed-income," she said.

NEPC does not typically recommend dedicated allocations to high-yield credit as it prefers to implement the strategies through a flexible manager.

"More flexible managers are actively managing their portfolio based on credit risk, duration risk and really trying to maximize the risk adjusted rewards for those," Reynolds said. "So, we'll see them in bank loan or the floating rate securities for inflation protection. We'll see them moving more towards those and probably being lighter on the riskiest high-yield credit. So, the added flexibility of them understanding the credit markets and the interest rate markets really gives them an edge."

Morgan Stanley Investment Management finds that its asset selection within spread sectors, particularly higher yielding credits, should also help offset any further rise in rates.

Within high-yield, it continues to favor lower credit quality, primarily single Bs vs. BBs as high-yield typically outperforms investment grade rated bonds in recovery periods, according to a recent insights article that noted that as default rates have been reduced, allocating to lower quality bonds is beneficial for additional yield pick-up.

"Lower rated B rated bonds tend to outperform BBs if default risk continues to decline and investors reach for yield down the credit curve. Conversely, we believe avoiding low coupon, long duration BB credits should help mitigate the risk from a move higher in rates," according to the report from its global fixed-income team.

The firm's investment grade credit team identified industrials, semiconductors and energy as credit sectors that present opportunity.

Pockets of cost-push inflation may tilt earnings to the negative in industrials, but "green shoots of demand-pull inflation, coupled with rational behavior among producers, would be broadly supportive of the credit profile," according to the firm, which finds that demand is healthy and bolstered by the macro trends of accelerated digital transformation and a sustained focus on increasing productivity.

Semiconductors present strong growth across markets that include computing, wireless, industrials, consumer and automotive, where the firm expects double-digit growth.

"From an ESG standpoint, Semiconductors are essential to improving the efficiency of end products and enabling the transition from analog to digital interfaces. Therefore, higher Semiconductor prices are likely to persist without comprising growth. We think chip manufacturers will continue to enjoy significant pricing power as long as demand outpaces supply," the report states.

Semiconductors are not without risk as Clemson's Alexander finds that an invasion of Ukraine by Russia significantly increases the probability of China annexing Taiwan.

"If China takes Taiwan we haven't even begun to understand supply chain issues. All semiconductors are coming out of Taiwan … The elephant in the room is what is going to happen to semiconductors and rare earth minerals, of which China controls over half the minerals in the world," he said.

Morgan Stanley views energy as a sector with positive momentum as the U.S. is one of the world's largest producers and one that has been disciplined on adding supply "lately." The firm finds that U.S. producers are unlikely to flood the market even in an inflationary environment because of supply chain issues and labor shortages in Oil Field Services, noting that "rising energy prices generally lead to improving cash flow for the producers."

As investors and allocators are concerned about the expected muted returns of the traditional public equity and fixed-income investments, Colorado's Vu finds that institutions should be more focused on their regional, sector and style exposures, the actual risks that they are taking following a prolonged period of central bank intervention and concerns about long-term growth and inflation.

"Although I have internal or maybe mental [return] targets of where I'd like to hit, I'm more concerned about the actual risk. Any moves or anything that we do in the portfolio next year or in the next five years are going to be centered around the question – does this increase or decrease the risk of the portfolio?" Vu said. "Whatever the return is, is sort of the side effect. Most people build portfolios saying I need to get X return and they will try to minimize the risk to get to that return … I want to understand what risks are in the portfolio and then I'll decide how much risk I want to take."

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