Fiducient Advisors, Nonprofit Investment Stewards Podcast
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Five Investing Paradoxes Impacting Nonprofits and Endowments

[00:00:00] Welcome to Nonprofit Investment Stewards with Bob DiMeo and Devon Francis from Fiducient Advisors. Bob and Devon are passionate about helping nonprofit organizations prosper. Whether you oversee endowment, foundation or retirement plan investments, this podcast exists to help stewards improve performance, reduce costs, and discover strategies that enable your charitable organization to prosper and advance its mission.

[00:00:26] Now onto the show. Hello, and welcome back to the Nonprofit Investment Stewards podcast. I'm Bob DiMeo, always good to be joined by cohost Devon Francis. Today we have what I'll call an insider episode, no guest, just me and Devon chasing down very interesting, very pressing and candidly at times, what can feel like very confusing matters that anyone overseeing endowments, foundations or even investments in general face today. We'll call this our endowment investing paradox episode, and we hope listeners [00:01:00] find it timely and useful.

[00:01:02] First, Devon, how are you? And as we approach fall of 2022, what feels different to you this year? Well, I'm great, Bob, as usual, but in terms of what feels different this year, what doesn't feel different this year? That's a good point. I'm gonna have to go with the market returns and, you know, year to date, significant losses in both stocks and bonds this year.

[00:01:24] Which of course has investors on very high alert if you will. So, so that's, from my perspective, Bob. What about you? How do current circumstances differ from the past couple of years from your perspective? Well, Devon, we definitely concur on the market side and we'll get more into that throughout the show, but it does feel different in other ways.

[00:01:41] I will say this I've really been enjoying in person meetings with clients which have picked up quite a bit. There are some clients we've added clients didn't even meet them in person, you know, maybe you were hired over Zoom. So it's great to meet with investment committees and such. And then as you're well aware, our client conferences are back in swing.

[00:01:57] So we had our big Rhode Island conference [00:02:00] in June, and then we have our investor client conference coming up in Chicago on October 13th. So that's fun. And then I guess lastly, I'd mention RFP activity. Most of our business comes in through a request for proposal and with the rocky markets, with stewardship concerns and such, we've seen a real spike in terms of inquiries for new business.

[00:02:24] So, that's fun too. Yeah, absolutely. And, um, it's funny, you mentioned meeting with new clients for the first time in a face-to-face manner. And I would say that the most common refrain that I hear is you're so much shorter than I expected so, uh, it's been nice hiding behind in the screen for a couple years, but now folks understand I'm only five feet tall.

[00:02:46] So anyhow, let's kick things off with our first paradox of the day or counterintuitive principle. And that's the notion that stability in markets can in and of itself create instability. So why don't you [00:03:00] share a little bit about that? Sure. Devon. So I wrote about this back in one of our newsletters in 2020, called it the top financial challenges facing nonprofits.

[00:03:10] And this concept I referred to is the complacency challenge, I based my observations on work performed by economics professor, the late Hyman Minsky. And I'll just share a quote with him, which I think will be helpful. He said stability leads to instability. I'll say it again. Stability leads to instability.

[00:03:31] He goes on to say the more stable things become and the longer things are stable, the more unstable they will be when the crisis hits. Now I'm sure to our listeners that sounds counterintuitive. So, let's unpack it a little bit. Minsky says that stable economies and stable financial conditions that they actually sow the seeds of their own destruction.

[00:03:55] And you might be scratching your head saying, well, why is that? And it's really because [00:04:00] stability itself produces risk-taking behavior. If you think of things like speculative borrowing or undisciplined spending or less focus on expenses. The stability fosters risk taking, and we all do it in our own lives.

[00:04:18] Think about when things are going really well. And maybe you edge up a little bit, go to that nicer restaurant or make that extra expenditure. And Minsky talked about how economies and markets do this in aggregate fashion. So, as we mentioned earlier, endowment investment committees, many stakeholders, right?

[00:04:36] Things are rocky this year. So maybe spidey senses are up a little bit and it doesn't apply as much. Frankly, when I wrote this in the first quarter of 2020, it really applied, but markets are rocky. There's less stability, but if you oversee investments, this is a really important, long-term principle to grasp.

[00:04:54] And it, it is absolutely related to investments, but it also applies to [00:05:00] other areas. If you think governance, if you think expenses, if you think investment consultants, professionals and vendors that you're using. It's a good concept, if you will, to grasp and to not let stability sort of create complacency.

[00:05:16] So that sort of outlines things in high level. Would you add anything, Devon? No, I think you hit it on the head, Bob. You know, it almost feels like recency bias, writ large. Um, so, continued asset growth lulls investors into a false sense of security and the, they think the only way is up and then they borrow and invest and borrow and, and then, you know, the crash comes about.

[00:05:39] So, uh, yeah, it's an interesting, interesting paradox. It is. And, and so let's jump to our second paradox. That is endowment spending. And I remember some time ago working with a group of nuns, actually a large religious order, really sophisticated investment committee. And there was sister Rita who [00:06:00] was a mathematics professor at a university out west.

[00:06:02] She sat on the investment committee and she did a lot of analytics on how spending less today from an endowment or frankly from any pool, but spending less today actually enables a charitable organization to spend more tomorrow. And she actually created a software program. Like the, the crossover seemed to occur at like generally 17 to 19 years out.

[00:06:24] If you spent less, you could actually advance your mission more and spend more over the long haul. What would you share on this principle of spending, Devon? It's interesting, Bob, it's almost like I planted this question, which I didn't. But as we've mentioned before, we have our fiduciary governance calendar and every first quarter meeting, we talk about spending practices with our endowment foundation clients.

[00:06:51] So last quarter, when we were having these conversations, within the governance calendar materials, we modeled out the impact of different spending [00:07:00] practices. So, we took a, uh, hypothetical portfolio, a 50 million portfolio beginning in 1990, and we modeled out these spending practices over this 30-year timeframe.

[00:07:12] And we ran a 4% spend as well as a 5% spend. And then we also looked at a hybrid approach, which factored in inflation as well. So, yeah, sister Rita was exactly right. We just did it via Excel spreadsheet, but we didn't have her fancy software, but yeah. So, the 5% spending policy, of course, at the end of this 32 year period, you had a smaller corpus.

[00:07:40] So you had eaten away at the investment pool, but really interestingly, the 4% spending allowance ended up being more in dollar terms than the 5% spend by the end of the exercise. And I don't know what exactly, what year in the study that the [00:08:00] crossover occurred. But I think if I look at the line graph, I think you might be right on target right about year 17 or so, where all of a sudden that you know, the 5% spend has eaten away at the corpus to such a substantial amount.

[00:08:17] That the 4% spending allowance actually becomes more in dollar terms. So at the end of the exercise, you know, we provided a table probably no one even looked at it, cuz there were too many numbers and, you know, too much data that we were sharing. But the accumulative spending over that time period for the 5% spend of course was higher than the 4% spend.

[00:08:42] But not that much higher, it was about $5 million higher. But the ending endowment value for the 5% spend organization was much lower. It was about $35 million lower. And then of course, the annual spending on a go forward [00:09:00] basis according to that 4% versus 5% calculation, the 5% spend was actually, you know, ended up being lower over time because you had eaten away at the corpus.

[00:09:11] So it is an interesting concept. It does seem kind of paradoxical. The thing that we need to think about with spending is you need to have a policy in place that allows for intergenerational equity. So you don't want to spend too much now and rob future generations of the benefits of the asset pool, but you also don't want to pinch too many pennies and not spend now and rob the current generation.

[00:09:39] So, it's all about striking a balance. And, and so that's well put and, and certainly something important for stewards to keep in mind. Maybe you wanna comment a little bit on spending trends in general that listeners, uh, really might want to take note of? Yeah, spending trends over time tend to [00:10:00] be pretty boring.

[00:10:00] Most institutions use a percentage of a moving average. Um, so, we tend to not have particularly dynamic discussions about changes in spending policies. However, what has been coming up frequently in recent months is, um, the impact of inflation. And investors coming to us and saying, should we be adjusting our spending policy based on current inflation levels?

[00:10:28] The fact that inflation is north of 8%. You know, we, we usually have a four to 5% spend, is that unreasonable knowing that our costs are going up. And the way that we've typically responded to clients when they do raise that question is to think about the long-term time horizon. So, with an endowment or a foundation, you're looking for the asset pool to exist in perpetuity, particularly on the endowment side.

[00:10:54] And if we look at long term break-even inflation levels, the [00:11:00] market is still pricing in relatively modest inflation. So somewhere around two, two and a half percent on a long-term basis, so on a 10-year basis. So, despite the near-term pain that the very high inflation rates is causing, we would not be advocates of adjusting spending practices based on the current inflation levels because we think ultimately we'll settle down to a more reasonable, long-term inflation picture.

[00:11:30] All right. Thanks for those great insights on spending. Let's move to paradox number three, and that is recessions and how markets react. And as of this recording, we don't know when you'll be listening, but as of this recording, GDP growth in the US is contracted for two consecutive quarters that often but not always indicates we're in a recession.

[00:11:50] And maybe just a little sidebar here, if you're wondering who determines if in the US who, who determines if we're in a recession, there's an independent body of 8 economists called the [00:12:00] business cycle dating committee. They determine after the fact when recessions begin and end. Again, as of now, the US is not officially in a recession.

[00:12:09] And to be fair, it could go either way with jobs being so strong, but other areas showing weakness. But anyway, recession is top of mind for many investors. And a question for you, Devon is how do markets react regarding recessions? And should investors be fearful now? Um, Bob, I'm gonna tackle the, the second part of the question is regarding, should investors be fearful?

[00:12:35] But our answer is no. So, recessions are a normal part of the economic cycle. On average, they occur about every six and a half years or so and last about 10 months. So it's, it's just the normal course of events, economies expand, economies contract. You have that, you know, little wavy line over time.

[00:12:54] And the reason that we don't think that investors should be [00:13:00] fearful in addition to the fact that recessions are just a normal part of the economic cycle is that we invest in markets. We don't invest in economies. And the market doesn't follow the exact same path that the economy does. So, on average, the market tends to peak about seven months before the economy does.

[00:13:19] And then the market tends to trough or bottom about four months before the economy bottoms. So, by the time it's widely acknowledged or accepted that the economy is in a recession, the market may very well be on its way back up. And another thing that we think is really important is that historically bull markets tend to be much longer than bear markets.

[00:13:41] So on average, they last just about six years, whereas a bear market lasts just over a year. And the cumulative return for a bull market is over 260 percentage points over that approximate six-year timeframe while the cumulative loss for a [00:14:00] bear market is only about 33%. So again, let me, let me share those, uh, data points with you again.

[00:14:06] The average bull market, when the market is going up, tends to last almost six years with a cumulative return over 260%. Whereas the average bear market tends to last only 14 months with an average loss of only 33%. So clearly bull markets where the markets are moving upward tend to be much longer with much more significant returns.

[00:14:34] So, you know, market timing is a fool's errand. I think everyone knows that. And if you remain invested in all types of market environments, ultimately your assets are going to increase over time if history is any guide. And we think that it is. Do you have anything that you wanted to share, Bob? Uh, I think you've nailed it.

[00:14:58] Uh, I, I, I [00:15:00] think that being, and you and I are both, uh, not only serve many endowment and foundation clients, but we sit on nonprofit boards and committees. And so, you know, if you have a pool that is intended to exist in perpetuity and advanced a mission, right?

[00:15:16] You have no choice but to ride through recessions and bear markets and such. You wanna do it in a thoughtful manner of course. But, um, but no, I, I think you've summed it up well. So, let's move to paradox four, which is market timing. And we already referred to it a bit in, in the last one. Um, so what are your thoughts and insights on market timing?

[00:15:36] So there are countless studies on the challenges of attempting to time the market. Most listeners have seen the studies, but just to set the table, I'll share an observation. Our research team recently communicated and they used Morningstar data for this, and they took a timeframe from January 1st, 1980.

[00:15:54] Through December of 2021. And they looked at the S and P 500. [00:16:00] So that's S and P 500 returns over a 41-year period. And basically, that's over 10,000 trading days. And as you would expect, the returns were just phenomenal over that long haul. But what happened if you missed the five best trading days?

[00:16:17] Out of the more than 10,000 trading days, if you missed the five best trading days over that 40 plus year period, you brought your returns down by a whopping 43%. What if you missed the 30 best trading days? You knocked your returns down by more than 90%. That's 30 trading days out of more than 10,000 days over a 41 plus year period.

[00:16:44] And so, I guess I'd give another important fact. Of the 10 best trading days over those 40 plus years, all of them happened during a recession and a bear market. So, market timing is indeed, you mentioned it, a fool's [00:17:00] errand. And then that kind of leads to, well then, what do investors do? What should good stewards do to mitigate the risk?

[00:17:05] We know you can't just park it generally. You can't park your funds on the sidelines because you are trying to advance this mission and have returns help do that. And so, we begin when we work with a new client or any client for that matter, we revisit periodically and we say, well, what are we out to accomplish?

[00:17:22] And I'm talking about from an organizational perspective. And if we can achieve our goals, our organizational goals by investing our endowment or foundation in treasury bills, the safest asset class in the world, we should. You know, people can chuckle and whatnot, because most organizations can't. However, it's a nice point of reference.

[00:17:44] If you will, being that we're only taking on risk that is necessary to help us advance our mission. So, we talk about the three levers. Every investor, certainly every nonprofit, has three levers. You have inflows. And that of [00:18:00] course is investment returns, but it's all sorts of contributions and maybe services that generate revenues and such.

[00:18:09] So you've got a set of inflows. You've got outflows, and then you have your required return. So what we try to do, particularly in this uncertain environment, is make it somewhat clinical and come back to what are our inflows? Is it a hospital trying to expand and treat more ill patients? Is it a university trying to grant more scholarships?

[00:18:29] Is it, you know, a service agency trying to do something, whatever the case may be. If you can make this somewhat clinical and say, we've got inflows, we've got outflows and we've got expected return. And if the expected return or the risk that's required to take on that expected return is too high, then you've gotta shift some of the other levers.

[00:18:49] You've gotta bring more in on the development front or spend less. But that's our suggestion on how to deal with these volatile markets and [00:19:00] it's pretty accepted that market timing just doesn't work. So you're much better off saying let's get our three levers right. Let's know that we're going to have recessions and bear markets from time to time.

[00:19:11] But because we dialed it right and we understand what's occurring, we hopefully have the ability and knowledge to ride that out. And then over the long haul, achieve these returns. Would you add anything Devon? No, I think you're absolutely right. And the statistics speak for themselves. So, um, you know, just, you gotta play the long game and know the history.

[00:19:34] And that's, that's key. Excellent. So, so let's tackle another paradox and, and we, you know, we've been sort of working towards this and that's the notion that when it comes to bear markets, things often have to feel really bad before they can turn good. What insights do you have on this Devon? Yeah, you know, I think all of these paradoxes.

[00:19:56] Paradoxi, I'm not quite sure what the plural is, but [00:20:00] I think they're all related. And really, they go back to the concept of economic cycles and market cycles. And it's only when things are really bad that folks and investors start to think, well, okay, how much worse can it get? And then maybe they're willing to dip their toe back in the water.

[00:20:17] There are some really interesting data points on consumer confidence and market returns. So historically, if you look back and you look at the consumer sentiment index, if you invest at the peak of consumer confidence, the 12-month subsequent return of the S and P is about 4%.

[00:20:36] I think we'd all agree that that's a pretty mediocre return. If you invest at the trough of market sentiment, when things feel absolutely the worst, the subsequent return of the S and P is almost 25%. So, you're looking at 25% by investing when things feel really bad. Whereas you're only looking at 4% if you invest when things feel [00:21:00] good and the market sentiment is at a peak.

[00:21:02] So I think looking at those types of graphs can be helpful and can give investors the stomach to be able to, uh, you know, stay invested through these troughs and then ride the wave up. There's an interesting quote. It's kind of a, a macab or axiom. Um, it's from Baron Rothschild that says the time to buy is when there's blood in the streets.

[00:21:25] And really that's when returns tend to be the best is when market sentiment is the worst. And, and then that's the turning point. Yeah. So, moving on, uh, this last one isn't necessarily a paradox, but I think it's a useful principle that you've written about, and you've even mentioned it I think on the podcast in the past.

[00:21:45] So, Bob, what can you share with listeners about the dangers of extrapolation? Yeah. So the, the fun way to remember the dangers of extrapolation is to think about Elvis impersonators. And I believe the first Elvis [00:22:00] impersonator was a young man named Jimmy Smith and that dates all the way back to 1959.

[00:22:05] And so, Elvis wasn't even a giant star at that point, but he already had an impersonator. And I don't have the data in front of me. I saw the graph at one point in the data. And so, let's say it was young Jimmy Smith in 1959. And then, you know, by 1964, there were 30 Elvis impersonators. And then by the late sixties, there were a couple thousand.

[00:22:29] And by the time of his death in the seventies, there were, well, the point is if you extrapolate the growth of Elvis impersonators, I think it called for that by 2025, 1 of every three Americans will be an Elvis impersonator. Right? So, you know, I did this once at a conference. I said, look to your left, look to your right.

[00:22:47] Who's gonna be the Elvis impersonator? And of course, that's not the case. And, but it points out kind of the silliness of just extrapolating trends in the recent past. And so, I think we [00:23:00] as stewards owe it to our nonprofits and their missions to be informed and kind of a thoughtful voice of reason and it definitely applies to good times, but it also applies to bad times.

[00:23:11] And just to circle back to the last paradox, right? When everyone's feeling bad, you're feeling bad too. Right? And that's when you have to continue the discipline, whether it be the three levers, the dollar cost averaging or whatever the case may be. So again, we as stewards owe it to our nonprofits and their missions to be that voice of reason.

[00:23:32] So Devon, this was fun. Anything you would add or underscore? I guess just to reiterate the point that, um, the natural order of things is cyclical. So, you think about the ocean tides or the waxing and waning of the moon, the economy and the markets work in the same way. There are cycles of expansion and then cycles of contraction.

[00:23:54] And really the most important thing is for investors to keep in mind that there will be good times and [00:24:00] there will be bad times, but all of the data points to the importance of remaining invested in all types of market environments. Very well put, Devon. Thank you so much. It's fun to do an insider edition with you.

[00:24:12] Appreciate it. Absolutely. It was fun. Good. So, two quick things to close. One, a big thank you to our listeners, Devon and I receive analytics on the show and we are thrilled that many of the episodes right in the top 25% of downloads. And that's not just for non-profit podcasts, but all podcasts. So, a big thank you for listening and spreading the word.

[00:24:34] And then number two, these are volatile times, unprecedented times. And if you sit on an investment committee or you have anything to do with overseeing a portfolio, we'd love to learn more about you and also share how Fiducient Advisors is providing investment consulting to help literally hundreds of nonprofits manage their endowments and foundations.

[00:24:54] I'd encourage to reach out to me or Devon via LinkedIn or the email in the show notes. [00:25:00] So to all you good listeners, thanks for investing time to help your nonprofits prosper. We'll connect with you soon on the next episode. Thank you for listening to the Nonprofit Investment Stewards podcast. Click the subscribe button below to be notified of new episodes and visit fiducientadvisors.com for more information.