Fiducient Advisors, Nonprofit Investment Stewards Podcast
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Quarterly Quick Takes: Market Updates and Year-End Considerations with Brad Long

[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. It's always good to be joined by co-host Devon Francis. Hard to believe, but seasons are changing and we are headed into homestretch for the calendar year. And also, home stretch for the investment year.

[00:00:45] For many of us, timing's great to have Fiducient's chief investment officer Brad Long return to the show and arm us with meaningful insights for this fourth quarter and beyond. Devon, how are things? Right, Bob, as always, I am [00:01:00] excited about today's show. This is our quarterly quick takes, but with a twist.

[00:01:04] So you and Brad recently presented to ICUT or the Independent Colleges and Universities of Texas, um, the markets, a potentially looming recession, and how all that might impact nonprofits that count on endowment or foundation asset pools. So in today's episode, we'll bring listeners up to speed on what they might expect from the markets and the economy going forward.

[00:01:26] And we'll also drill down on what good stewards ought to be thinking about when it comes to things they can control like expenses, committee best practices, and more. So, Brad, as always, welcome to the show, and this should be a lot of fun. So Bob, you are a trustee with the Associated Colleges of Illinois, and I think a presentation you made to them earlier in the year led to you and Brad recently speaking to schools in Texas.

[00:01:53] So why don't you give us a sense of the purpose and timing of your talk? Yeah, that's right, Devon. [00:02:00] If you think back to fourth quarter of 2022, uh, the recession was looming then, and you frankly had almost universal opinion that we would see a recession this year. So, we thought we'd put together a program earlier this year for Associated Colleges of Illinois.

[00:02:20] Their, their school members really talking about recession, the markets, how might that impact your endowment? How might that impact your institution? And so on. And if you think about it, it's not just a recession looming or potential bear markets and so on. Most nonprofits, particularly higher ed, think about the demographic cliff and so on, but think of nonprofits overall.

[00:02:44] Where you've got challenges with earned income for some nonprofits, development or capital campaigns, the list goes on and on. So, we really talked about uh, not only the markets and economy, but controlling, as you mentioned, what we can control. And I began the presentation [00:03:00] with historical perspective which dated all the way back to the great financial crisis in 2008. It was a terrible downturn. The Fed slashed rates. Risk assets for more than a decade soared as a result of it.

[00:03:13] And then the pandemic came around, rates slashed again, inflation came back and, uh, and so on and so forth. But with that sort of historical perspective, it's probably a great time to turn to Brad. And Brad, maybe you can bring our listeners up to speed quickly on what occurred in 2022, which was unusual.

[00:03:33] And then really what we were expecting going into this year. And then we'll get into what we've seen and what we expect. Yeah, sure. Thanks, Bob. So, 2022, I think, you know, in short, the Fed got way behind the ball. Inflation was off into the races and they started to play a game of catch up. And what that really meant is in somewhat of an unprecedented way, and I'll actually, you know, my mother always said a picture is worth a thousand words.

[00:03:58] So we'll put one on the screen here, but [00:04:00] in an unprecedented way, the Fed said, Oh, you know, we kind of started late on inflation. We got to play catch up. And they started moving rates up in a material way. For those that can't see the graph on the screen or you're listening, effectively, the Fed moved faster and higher than they had really since the late 1980s, previous other cycles.

[00:04:20] We either, we didn't raise as much or we raised over a much gradual pace and that, that led markets down. And as we all know, right, 2022 led to a somewhat unique environment in which stocks and bonds both underperformed and not just underperformed, but in a material way. The difference though, what was interesting in 2022 is a fairly orderly selloff.

[00:04:40] Usually when you have markets down 20 plus percent, you'd have bonds down well more than 10%. Oftentimes, that coincides with kind of panic or high unease, you know, especially think of periods like the great financial crisis of 2007, 2008. Really, 2022 was almost orderly in a [00:05:00] way that the markets understood what was happening.

[00:05:02] It was saying, hey, rates have to go higher because inflation is high. And we understand that price impact on portfolios. And so, 2022 brought about a fairly unique environment, but as we got towards the end of 2022, and we started to think, well, what's next? What should we expect for 2023?

[00:05:20] We really thought there's three primary things that would be moving prices. And I won't go into these in detail because I know our listeners have listened to these in the past. Um, and there were three primary elements, persistent volatility, moderating inflation, and a bear market bottom. And if we were just to call pause on the year today, I would think we could pretty easily put a check mark by two of these. Moderating inflation.

[00:05:41] It's pretty easy to say, 9 percent last June. Three and change, depending on how you measure it today. That's moderation if I've ever seen it, inflation at a third. A bear market bottom, we're up well over 20 percent since October of last year. So you can call that statistically or mathematically a bear market bottom [00:06:00] and then persistent volatility.

[00:06:01] We'll give ourselves a half check on that. Yes. Markets have been volatile. Equities at the surface haven't been that volatile, though I'd say for practitioners, when you look under the hood, you've got NVIDIA up over 200 percent and SVB, Silicon Valley Bank, zero, uh, you know, they went out into bankruptcy, so that's a pretty widespread, but at the high level, you don't see as much volatility, but we do think that that's a longer or more persistent theme.

[00:06:25] And so that's really set ourselves up for A, how we've allocated for this year. And I think Bob and Devon, to get back to your point on controlling things we can control and really releasing the things that we can't, uh, and setting ourselves up for really positioning portfolios in a way that acknowledges that inability to control all factors, but making sure we do pull on the levers that we can to benefit our constituents.

[00:06:52] Thanks for that recap. I think it's helpful to, to go back to what our market themes were as we started the year and kind of take [00:07:00] a, take a look at, uh, how we've done and, and how our expectations played out. Bob, I wanted to ask you about, you made a really interesting observation in your presentation about expectations, events, and outcomes.

[00:07:13] And could you touch upon that? Sure, absolutely. And it's interesting because if we, I think I made the point, if we sat down with clients on January 1st of this year, and we basically said, hey, we're not entirely sure, but we're trying to get a sense of what the markets will do. Brad talked about a half check in terms of persistent volatility.

[00:07:36] Well, well, the markets at the surface don't appear overly volatile, but the events were certainly volatile and have been volatile this year. So again, if we sat down January 1st of this year and I said to you, not sure what the market's going to do, but I can guarantee you this, the war in Europe will continue.

[00:07:56] Tensions will escalate between the U.S. and China [00:08:00] relationship. We'll see some of the biggest bank failures in U.S. history. Earnings on S&P 500 companies will fall. U.S. Treasury debt will be downgraded. There will be huge concerns over commercial real estate. I mean, we can go on and on with this. If, if we had known with certainty that was going to happen on January 1st, we probably would not have guessed that markets would be somewhat within striking distance of all time highs.

[00:08:26] So I think that's pretty interesting and, and ultimately plays into some of the insights Brad will share with us on. So where do we go from here and how do we position an endowment foundation, that sort of thing? And so I think you teed that up perfectly well, Bob. So we've talked a little bit about the markets and the broad economy.

[00:08:44] So let's shift slightly to the, the management of endowments and foundations and what could be some practical points or pieces of advice for those overseeing investment pools. So, Brad, do you have any thoughts, I guess, let's start with the topic of diversification. [00:09:00] Diversification is kind of the, the 101 of portfolio management, right?

[00:09:05] And if you think about what, what's the simple reason why we and others kind of harp on diversification. It's a function of imperfect information. Bob just laid it out perfectly. Even if we had that type of perfect information in advance, predicting market outcomes is difficult. And so, if you have no information, you should just own a little bit of everything and try to diversify away your risk.

[00:09:29] If you have perfect information, you know exactly what the market is going to do, you should diversify not at all. You should own one thing and one thing alone. Cause you know exactly what's going to do the best. Now, reality obviously lives somewhere in the middle and we don't have perfect information.

[00:09:44] But we have quite a bit of information, either via historical context or markets and conditions, current economic conditions, right? So, we'll use those elements to stack probabilities in our favor. What's more likely to happen that we can never guarantee it. What's less likely to happen? Where are the [00:10:00] risks? All of that though, again, with the idea of diversification stacks together with humility, because coming into 2023.

[00:10:08] I think there was a lot of hubris looking across the street and prognosticators and economists, they would say something like, well, I don't know when the recession will hit. I know it will, but it's going to be somewhere between March 8th and March 23rd, right? It was, it was insane. But now to look back and think about, you know, if the market, if you're not humble, the markets will humble you, you know, why should you be diversified.

[00:10:30] And, you know, this is a classic chart, but it's, it's a good one. It just simply shows asset classes in a given calendar year and the differences and variances of those returns. And if this looks like a random quilt chart, especially for individuals like me who are colorblind, um, that there's very little pattern here.

[00:10:50] It's because there is, right? And any given calendar year, and especially if you shrink that shorter to a quarter or a half a year or a month, right? We don't [00:11:00] have a great sense of exactly what will perform and when. And so, in order to reduce, uh, that variance and frankly put at risk the long-term objectives of our portfolios, we should think about and have, practically have prudent diversification.

[00:11:16] That doesn't mean own everything, right? That's, that's divorcefication. A colleague of mine calls that. Um, but we should be thoughtfully diversified to, you know, kind of hedge against those and help reduce that volatility of not meeting our main goals over the time periods in which we need to meet them.

[00:11:34] So, while we're talking about diversification, can you speak a little bit about the case for owning international equities? Um, folks understandably have gotten frustrated if they've had exposure to international and domestic equities have outperformed quite substantially. So, what's the rationalization there for, for an allocation to international?

[00:11:54] Yeah, it's, it's, uh, it's a easily justifiable, you know, point to say, [00:12:00] hey, the S&P is really the only game in town. It has been for the last decade. Why should that be different this time? Well, at the, call it the 100,000-foot level, right? Just from a, the majority of the world's economic output lives outside of the U.S. borders.

[00:12:14] The majority of stocks that exist that are theoretically owned or sold exists outside of our borders. The majority of the population of the world exists outside of our borders. And so, to think that our investable universe lies between California and New York is a fairly narrow window. But we also should start to think about, again, stacking probabilities.

[00:12:36] What's the likelihood of, you know, say the U.S. just materially underperforming international over the next 10 or 15 years? Well, yeah, I kind of call this the, you know, the laws of economic gravity, right? There's a reason that trees don't grow, uh, you know, into space that you start to pull back on some of these threads.

[00:12:53] And we've seen these periods of material outperformance and underperformance here in the U.S. and for those that can't see, we have on the [00:13:00] screen. This is not the first time this has happened that the U.S. has been the only game in town as it was in the 1990s and early 2000s. Or, you know, when it's materially underperformed like it was in the 19, mid-1980s, actually post the last time we had a material fed rate hiking cycle and then started to fall and we had, uh, inflation or, you know, as we saw, uh, kind of coming into some of the economic and commodity super cycle.

[00:13:24] We saw, you know, from the late 90s into really right before the GFC. And so, as we think about these past periods, right, this is just an example of which, you know, this stretch has been longer since we've seen since the 1970s, but we'll just offer three things to say, you don't put the majority.

[00:13:42] Of your money outside of the United States, especially as a U.S. investor, it's not something recommend. Given the fact of cyclicality and where we've kind of this long live cycle of outperformance, given the fact that valuations, meaning the attractiveness just on a fundamental basis outside the United States are [00:14:00] materially better.

[00:14:00] Uh, than they are here and let's just pick on China because China's the poster child of concern and worry and angst. You know, China is trading near its global financial crisis lows, right? At a time when we were wondering will the sun rise again? So, valuations far more attractive. And then finally right as you stack on top of that.

[00:14:21] The U.S. dollar has been a very strong performer since the global financial crisis. And so, anything you own outside of the United States, if you translate that back, when the dollar is rising, it's worth less. So, if we start to stack these things, right, these cycles of outperformance don't last forever, that valuation over a long period of time is very meaningful.

[00:14:40] And then if a currency at the very least, not a headwind, but perhaps a tailwind, can provide not just diversification, but opportunity for investors going forward. So, it doesn't mean only own stuff outside of the United States, but it does mean that we think there's pretty material opportunity there today for those that are willing to look [00:15:00] forward rather than just look through the rear-view mirror.

[00:15:04] Great. And then maybe the last directly investment related topic. Let's, let's talk a little bit about cash versus bonds. So right now, money market yields are hovering around 5%. So, what's the case for investors to even have a traditional fixed income allocation at all? And in particular, I'm thinking about endowment foundation asset pools.

[00:15:25] Can you talk a little bit about the rationalization for bond exposure? Yeah, it's, it's a great question. And one that we're getting a lot, given the fairly unique environment. A, cash is actually earning something for the first time in over a decade. And B, the longer you add duration, meaning you own securities that are one, two, three, five, 10 years out, you actually don't earn as much as, as something that, uh, is a shorter maturity security.

[00:15:53] And so, you know, that, that's the inverted yield curve. And so investors are just saying, Hey, why, why should I? Well, look, if we just take the [00:16:00] scorecard and just say cash versus bonds. And I'm defining bonds as the Barclays agg. 89 percent of the time, bonds outperform cash, just over rolling three-year period.

[00:16:10] So like, if we just don't know a whole lot, we just want to say, okay, well, we're at Vegas, right? Does the house win or do I win? Like the house usually wins. And so, bonds usually win in those instances. Well, now if we start to zoom in and say, well, it's not, I'm not really thinking long term, right?

[00:16:25] I'm an endowment, but maybe my time frame is creeping in. Well, even if we just define it over one year time periods, almost two thirds of the time, or a little over two thirds of the time, bonds tend to outperform cash. Um, and then you've got investors that would say, Hey, well, it's not necessarily about timeframe.

[00:16:41] It's more about, I'm really worried about the recession that we were talking about this looming recession. Well, in that instance as well, almost coincidentally, 66 percent of time, almost the exact same, when the S and P drops by 15%, bonds tend to pretty materially outperform cash. So that's just kind of the facts. [00:17:00]

[00:17:00] But then if we take into context today, right, where we believe we are near, if not at, the end of the fed's rate hiking cycle, um, if we do have a moderating, if not slowing, economy, bonds can play a really, really important role in protecting the portfolio. And what we mean by that is cash tends to protect itself.

[00:17:20] Right? So, you put a dollar in, you get a dollar out plus the yield. Bonds tend to protect the portfolio, meaning you put a dollar in, but if rates fall because the economy is weakening, that can actually have a more additive effect. So, it's not just the $1 you're getting back plus your yield. You might get back more because of the price return and movement.

[00:17:41] So we think they're a better, more efficient diversifying asset. And frankly, in the position and current economic environment we're in, they're an additive role in the portfolio. Again, getting back to this principle of diversification, to help diversify our risks away. Right. That's really helpful.

[00:17:57] So Bob, let's shift over to you. You [00:18:00] regularly espouse the importance of an organization, particularly a nonprofit organization, engaging in what you call the three levers exercise.

So can you touch on that? And it's important, particularly in today's environment. I can and will, Devon, and it's interesting.

[00:18:16] We've talked about three levers before, and just as a reminder to our listeners and viewers, uh, the levers would be any nonprofit organization, virtually almost any investor, has some form of inflows. For a nonprofit, think earned income, think charitable donations and so on. But you've got inflows.

[00:18:36] You've got outflows, and then you have a required rate of return that you're looking to achieve within the endowment or whatever the investment pool or portfolio is. And I would say because of the reasons that Brad touched on, the uncertainty that we're experiencing, will this other shoe drop with respect to an actual recession coming forth, so on and so forth?

[00:18:56] You could argue that it's as important [00:19:00] today as it's ever been to be broadly, thoughtfully diversified. And, uh, so I know we'll talk about this in a moment, uh, controlling what you can control. It's really a critical time in our opinion to have courageous conversations about the three levers, I would say, mind your three levers. Sitting down today with the stakeholders in your organization and really determining what are inflows today and what can and should we expect them to be going forward with a realistic view or perspective.

[00:19:33] Outflows, same thing. And sometimes, what's left when you get to portfolio expected returns, you just can't get there from here. You can't earn enough. So, you have to have these courageous conversations about inflows and, and sometimes even more courageous about the outflows. So, as you embrace this concept, I know Devon, it's just an extremely important time for nonprofit leaders, for good [00:20:00] stewards, to be thinking and acting on this front.

[00:20:02] And in terms of thinking and acting, I think maybe now is a good time to flip the script, if you will, and pose a couple of questions to you, Devon, especially in the area of controlling what you can control, given that uncertainty, the high stakes. If we talk separate from investment strategy, Devon, what would you say committee members, board members, staff should be thinking about and perhaps doing right now?

[00:20:27] Well, exactly as you said, getting their three levers in order and having those courageous conversations is obviously crucially important. But beyond that, several other things. One is expenses. So that's a prime example of something that you can control. And it's really important to be aware of and have a solid understanding of the expenses associated with management of your investment program.

[00:20:52] So beyond just the investment management fees, you also need to be well aware of advisory fees, custodial [00:21:00] fees, really everything that kind of goes into the mix and not only be looking for the lowest cost option, of course, cost is important, but also thinking about the value. So, if you're paying active management fees, making sure that over a full market cycle, those active managers are outperforming net of fees.

[00:21:19] Of course, that's what you're looking for in the long term. Making sure that advisors are earning their fee and so on and so forth. So, expenses, that, that's a key thing. Along the lines of advisors, having members of your team, having outside advisors who are really a trusted resource. So, using an investment consultant that, you know, you can pick up the phone and call them and ask for their expertise on a variety of topics.

[00:21:47] That's something that we really aim to do for all of our clients, making sure that your auditor is a trusted part of the team as a resource for you. If you have accountants, um, [00:22:00] outside of your organization or nonprofit attorneys, making sure that you really have trusted relationships that can be relied on in a variety of scenarios. And then, governance.

[00:22:11] Governance is really the key. I think one of our earlier episodes, I think it's an episode number 60 with David Nierenberg, who's the chair of the Investment Committee for the World War II Museum. He made some really great points about governance. If, if you haven't listened to that episode, I do recommend it, but I'll summarize some of his key points.

[00:22:31] So, one point was that the mission of the organization should never excuse poor governance, poor leadership, a lack of focus, or poor resource allocation. So that was really his initial key point. Another point which I think is really important is the composition of the boardroom is crucial and the culture within that boardroom should really encourage questioning, dissent, [00:23:00] respectful disagreement.

[00:23:01] It should be, you know, going back to those difficult conversations that you referenced, Bob. It should be an environment that really encourages that type of dialogue. Number three, governance issues in non-profit and for-profit organizations are fundamentally very similar. So, boards and committees should really focus on the right things, making hard decisions, and not be distracted by the minutiae.

[00:23:26] Number four is board makeup. Diversity and inclusion are crucially important, including diversity of gender. age, race, ethnicity, experience, communication style. But David also made the important point that appropriate expertise and knowledge are also crucial. So, you have to have all of those elements coming together.

[00:23:49] And then I think two final key points that he made that are really important takeaways. One is that directors and trustees of a board, particularly [00:24:00] new folks, should be trained, mentored, and provided with the necessary resources. And then finally, re-election to a board should not be an automatic entitlement.

[00:24:12] Uh, it shouldn't just be a check of the box. It should be, you should earn your spot on a board term after term and board composition should be forward looking and should definitely include elements of succession planning. So, I think those are some really great points that David made, and they are all things that are able to be controlled by an organization.

[00:24:35] So taking care of governance and making sure that your governance house is in order, I think, is crucially important. That's so helpful, Devon, and it's a good reminder, as you particularly talked about the mission and more, I guess, is, uh, the takeaway that I have. So, we all have to have a heart around the mission and whether it be board members, committee [00:25:00] members, staff and such, a heart for the mission, but we need more.

[00:25:03] We need a strategy, a plan, execution, implementation. And, uh, I appreciate you reminding us of David's good points. So, with that, Brad, let's circle back to you. And, uh, you know, as we head towards year-end here and we think about positioning. We didn't even talk about alternatives and certainly that's part of the diversification, uh, strategy and such.

[00:25:27] But, but even separate from that, anything you'd like to add or underscore as we think of folks overseeing pools of money, whether it be endowment, foundation, that sort of thing, as we look at the fourth quarter and beyond? I think naturally, as we gaze towards the, you know, the new year, the, the natural inclination is what's new, right?

[00:25:47] So what's, what's new lately. October 10th, we have our quarterly webcast. We're going to kind of wet the appetite for some investors around, you know, what we're thinking for 2024 allocations. I can tell you personally, I spent [00:26:00] all morning, four hours this morning and our capital markets, uh, research team discussing and debating and conversing, having some of those courageous conversations around, you know, what do we do from here?

[00:26:11] What's best? Where do we lean in? Where do we lean away? And those things obviously will all be coming to a head in early November for us where we release our 2024 outlook. So, I would say, you know, maybe as we look forward, mark your calendar, maybe, because we've got a lot of things coming down the pike.

[00:26:26] That's great. Well, this has been fun. A little bit of a, as Devon mentioned, a twist on this format, but always nice to get together with you, Devon, and always great to have you on the show, Brad. Thanks so much. So, with that, I will mention that the three levers exercise that was mentioned several times here and the importance of diversification mentioned as well.

[00:26:48] If you oversee a portfolio and you're just not certain that things are positioned as they should be, feel free to reach out to me or to Devon on LinkedIn or on the email that appears in the show notes. So. to all [00:27:00] you good stewards, thanks for investing time to help your nonprofits prosper. We'll certainly connect with you soon on the next episode.

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