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Top Concerns for Private Foundations: Financial Volatility and Target Returns

A Commonfund Viewpoint

In this year's Council on Foundations–Commonfund Study of Investment of Endowments for Private and Community Foundations® (CCSF; the "Study") we asked a new question: What are the top two current concerns to your institution?

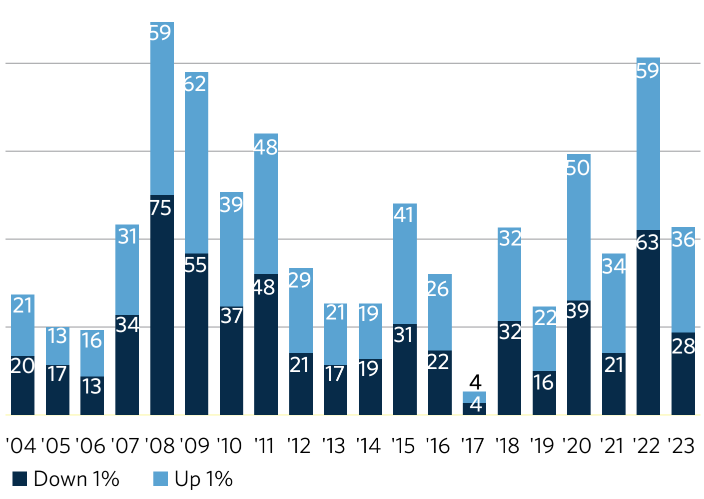
Respondents were presented with a list of options that included inflation, asset allocation, spending policy and fundraising, among others. Private foundations' most often cited concerns were long-term volatility in the financial markets—30 percent of private foundation respondents selected this as one of their top two concerns. While 27 percent of respondents indicated that not meeting target returns was their most cited concern. In this viewpoint we dig into data related to those concerns, which are interrelated with the third most-cited concern for private foundations this year: inflation.

LONG-TERM VOLATILITY IN FINANCIAL MARKETS

Financial markets have been roiled by uncertainty and volatility, especially since the COVID-19 pandemic hit in 2020 disrupting global supply chains, leading to the highest level of inflation, and subsequent interest rate hikes, seen in decades. This has been compounded by intensifying geopolitical risks and the unknowns of an election year encompassing a majority of the global population. This has translated to volatility in the financial markets that has reached levels unseen since the Great Recession. In 2022, for example, there were a combined 122 days in which the market fluctuated by 1.0 percent, the highest since 2008. In 2023, markets calmed with 64 days when that level of volatility occurred, a reduction from 2022, but higher than most of the post-Great Recession years.

S&P 500 DAYS WITH +/- 1 PERCENT MOVE RELATIVE TO THE LAST 20 YEARS

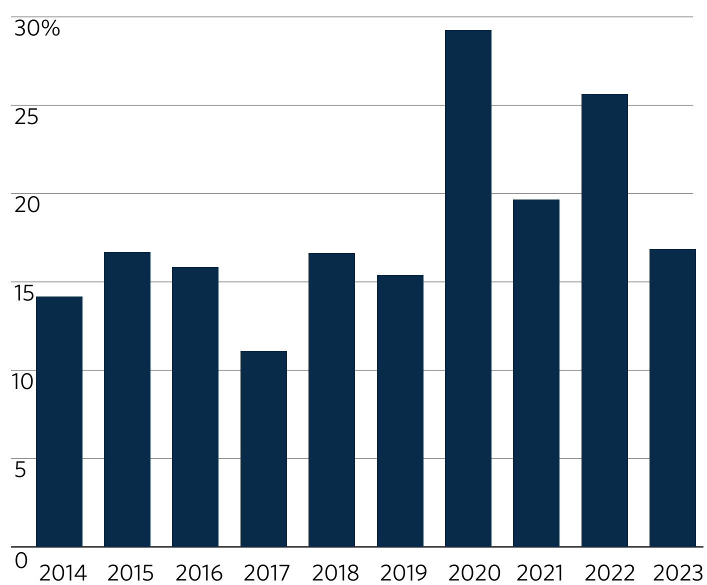
numbers in percent (%)



Source: Bloomberg

The VIX, a key indicator of public market volatility, showed a similar pattern. The index has averaged 20.84 from 2020-2023, ranging from an average annual high of 29.25 in 2020 to a low of 16.85 in 2023, indicating a reduction in volatility over that time. But looking at the longer term can illuminate why respondents may view volatility as a key area of concern: the 2023 average index value was higher than all years from 2014-2019. This is reflective of the sense that while measures like inflation and volatility may be coming down from a recent peak, they are still above expectations set in years prior.

VIX ANNUAL AVERAGE



The CBOE Volatility Index or VIX is a real-time index that represents the market's expectations for the relative strength of near-term price changes of the S&P 500 Index.

Source: Bloomberg

Within CCSF Study data, we can also see why volatility is one of the top concerns this year. For example, we can look to fluctuations in net returns year to year: for private foundations, the 2021 average return was 16.3 percent, followed by -12.0 percent in 2022, and 12.6 percent in 2023. While long-term returns are more reflective of an institution's ability to serve their mission, these 20+ percentage point changes in returns year over year in both 2022 and 2023 may have contributed to this year's top concern.

For private foundations the standard deviation of net returns, a standard measure of volatility reflecting the daily divergence from the mean, has risen significantly from pre-2020 levels. This figure spiked for the three-year standard deviation in 2022, but the five- and 10-year standard deviations continued to rise in 2023, reaching a five-year Study high at 11.0 percent and 9.2 percent respectively. From 2019 to 2023 each measure of standard deviation of private foundation returns increased by more than 27 percent (71.9 percent for the five-year standard deviation).

ANNUALIZED STANDARD DEVIATION OF NET RETURNS FOR PRIVATE FOUNDATIONS

numbers in percent (%)

Standard deviation	2019	2020	2021	2022	2023
3-year	6.8	11.1	10.5	12.1	9.7
5-year	6.4	9.0	9.5	10.7	11.0
10-year	7.2	8.1	8.5	8.9	9.2

All of these indicators may point to an environment in which volatility continues to be higher than in prior years. This may also point to the increasing importance of risk mitigation strategies, such as stress testing the portfolio (38 percent of private foundations that took any action on risk management did so, according to this year's Study), or conducting a formal portfolio risk analysis (33 percent). While only 56 percent of private foundations reported defining risk in their Investment Policy Statement (IPS) in 2023, this may also be an important first step for those concerned with the impacts of volatility.

NOT MEETING TARGET RETURNS

In this year's new question regarding top concerns, 27 percent of private foundation respondents reported that not meeting target returns was a top concern. What are private foundation's target returns, how many private foundations are meeting that benchmark, and how is inflation related? These are all key questions that Study data can tease out.

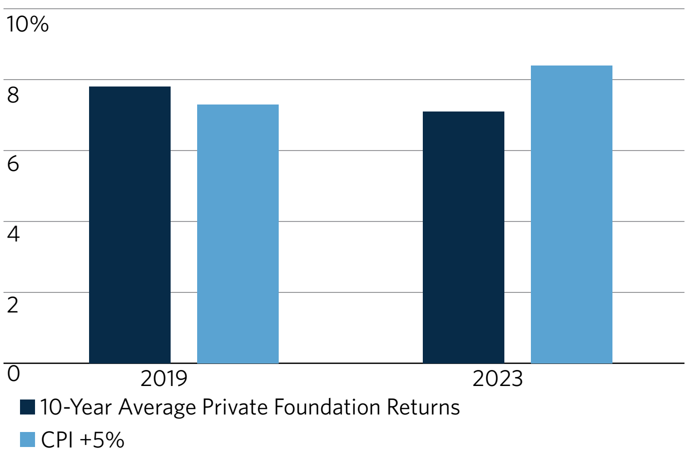
Most private foundations—78 percent—reported having a long-term return objective. For those that do, 7.1 percent was reported to be their long-term objective. The average return target is similar across size cohorts, ranging from 7.1 percent for private foundations with assets between $100 and $500 million, to 7.2 percent for those with assets over $500 million.

At the same time a plurality, 42 percent, of private foundations reported using a percentage spread above inflation as a method to define return objectives. That figure ranged from nearly half, or 47 percent of the largest private foundations, to 34 percent of those with assets under $101 million.

This makes clear that the ability to achieve target returns is not only a function of investment strategy and returns, but also of inflation. For example, let's say an institution is using a standard "CPI +5%" methodology to determine their target return. In that case, in 2019 when CPI was 2.3 percent, the return target would've been 7.3 percent. In 2019, the median 10-year return for private foundations was 7.5 percent—in other words, more than half of private foundations met a long-term target of CPI +5% in 2019.

Looking to this year's data, we see an increasingly challenging environment for meeting target returns. As of December 2023, the 12-month change in CPI was 3.4 percent. In this case, CPI +5% is 8.4 percent—well above the 7.1 percent average 10-year return reported by private foundations this year. In fact, a private foundation would have to be in the 88th percentile of 10-year returns, or above, in order to meet CPI +5%.

10-YEAR RETURNS COMPARED WITH CPI+5%



Source: CCSF, Bureau of Labor Statistics

Top concerns for foundations are ever changing and evolving. We will continue to survey on top concerns in each of our benchmarks studies to look for commonalities and differences between the different segments with the hope that we can provide some insight into how they are facing these challenges.

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