Top Five Questions of Nonprofit Fiduciaries

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The turbulent start to the New Year has led governing boards, investment committees and staff to question what’s next for the markets and what they should do about it. Below are the top five concerns and questions we have heard followed by our guidance for fiduciaries.

What Should We Do?

While human behavior often conditions us to “do something” in response to external stimuli, the most important guidance we offer clients is to be patient and stay the course. In counseling our clients not to focus inordinately on short-term market swings, we do recommend that you plan for the challenges of tempered returns over the next five years. Believe in your policy portfolio and your Investment Policy Statement (IPS); however, revisit your assumptions and make sure that your IPS accurately reflects your risk tolerances and goals. An effective IPS is a dynamic investment framework to guide your decisions through market cycles. It should be flexible, but with sufficient rigor to protect the temptation to overreact and “trade” out of down markets.

As we outlined in our 2016 investment outlook, we believe that endowments and foundations will be challenged to achieve their long-term goal of a five percent real return over the next several years. The process of unwinding or slowing the historic global stimulus policies since the financial crisis will likely lead to a re-pricing of risk assets, higher volatility and lower market returns over the next five years.

Investment committees and governing boards are well-served to assess all of the levers of their investment policy and broader enterprise. This certainly includes asset allocation, but also, and to the extent possible, spending policy and levels, development and gift flows and debt capacity.

How does Commonfund take advantage of a temporary market move and a longer term cyclical change?

Short term market moves are typically driven by momentum and flows while cyclical changes are usually based on more fundamental factors such as valuations and earnings. We allocate to managers who can take advantage of short term disruptions, but generally favor managers with longer term cyclical views. As an example, we do not believe that sub-$30 dollar oil is sustainable any more than we thought that $145 dollar oil was sustainable in 2008. We view current oil prices as a relatively short-term supply imbalance and not a foreboding of an imminent global recession. As such, we continue to maintain a modest overweight to equities (particularly low-volatility strategies), but with underweights to energy producers who face slow growth or in the case of Brazil, Venezuela and Russia, deepening recessions. Moreover, while our focus on valuation sensitive securities has been challenged in the current narrowly driven market environment, we
remain confident that fundamentals will soon matter again and that the markets will discern between sectors that will benefit from the drop in energy costs versus those that will be challenged.

How significant is the risk of a recession and bear market?

In the United States, we see limited risk of a recession in 2016. The U.S. economy is projected to rebound to a two to three percent pace by mid-2016 and earnings growth outside of the energy and materials sector is still solid. The S&P 500 Index, however, is close to a technical bear market level, having dropped 15 percent from the highs of last summer, including about seven percent this year. We would not be surprised if U.S. equities were still to fall modestly from current levels, but we would view that as an opportunity to rebalance. That said, we brought down equity risk in portfolios in the second half of 2015 from levels of the last few years, anticipating a more challenging return and volatility environment into 2016 and beyond. Outside of the United States, energy and materials producing economies are already in recession and we maintain an underweight to those sectors.

What are the risks of contagion from the decline in oil prices and the economic challenges facing China?

We view the risks of a broad global contagion to be measurable, but nonetheless modest, especially for the United States. Globalization reminds us that the world’s capital flows are interconnected and that no economy is truly immune to systemic shocks elsewhere in the world. The risk of a further decline in oil prices and the economic slowdown in China is that it may export deflation globally – which would in turn weaken output. The typical policy response to this condition is more accommodative monetary policy, but this tool is limited after the historic levels of monetary stimulus since 2008 – although central banks in Europe, Japan and China have now signaled new potential for added stimulus.

We expect that the Fed may signal a holding pattern near term and move more slowly in the coming quarters to raise interest rates as a result. The slowdown in China will have a greater impact on its largest trading partners, such as Germany but less so in the United States as China represents less than one percent of U.S. exports. U.S. oil producers are feeling the strain of low prices and this pain is particularly felt among shale oil producers whose average breakeven cost is $50 per barrel. The result will be an increase in bankruptcies in the energy sector and local economic weakness, but not at a level to dramatically impact U.S. growth. The current environment reminds us of the challenges that unfolded in the spring of 1986 when a sharp drop in the price of crude oil to $10 per barrel produced a recession in the oil-producing regions of the U.S., but ultimately provided stimulus to consumers and those businesses that use energy as an input cost. The initial impact was a 10 percent drop in equity prices and a test of the economic cycle, but by year-end both the economy and the stock market recovered as the benefits of lower energy prices boosted consumer spending and non-energy business activity.

How is Commonfund protecting portfolios from higher volatility while seeking opportunities for growth and return?

In this challenging market environment, we seek to reduce volatility by (1) allocating to lower volatility equity strategies and (2) eliminating “hidden” equity exposure. We will seek to reduce equity exposure in hedge portfolios by increasing allocations to long/short strategies that are intended to produce returns from alpha (manager skill) not market exposure. Several years ago we sought to incorporate low-volatility equity strategies into our investment strategy as we believed this would help our investors weather the drop in the price
of oil as these strategies generally have only five basis points of exposure to the energy and materials sectors. We also looked to reduce credit exposure, especially in high yield fixed income which tends to be highly correlated to equity markets, specifically the challenges in the energy sector. For investors that can accept increased illiquidity in their portfolios, we believe that there will be significant opportunities over the coming years from market disruptions that are taking place now that will eventually include the emerging markets and the energy sector.

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