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Financial regimes and nonprofit governance

Steering through the challenges

GOVERNING INTELLIGENCE

About the author

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The fluctuations of financial markets are the stuff of headlines, television feeds and daily blog posts. But over the longer term, it can be argued that the political and economic environment in which markets function has a more defining effect upon investment outcomes. This is particularly true for endowed nonprofit institutions, which, with their perpetual investment time frame and twin goals of financial support for their missions and maintenance of the purchasing power of their endowments over successive market cycles, cannot afford to be out of the market for any lengthy period.

This political and economic environment is sometimes referred to as a climate, but a more appropriate term is regime, a word that encompasses not only the ebb and flow of political parties and economic forces but also carries with it a connotation of structure and, to some degree, permanence as long as a given regime persists.

Regimes can be analyzed productively in hindsight as a historical matter; it's more challenging to discern the salient characteristics of a regime while one is living through it. Moreover, for fiduciaries of endowed nonprofit institutions, the daily noise of markets and the pressure to deliver superior endowment performance in any specific period can serve as powerful distractions that leave little time to draw back and appreciate the structural factors that may be creating, or limiting, investment opportunity.

In this paper, we attempt to provide guidance for fiduciaries and asset owners as they seek to steer their institutions through the governance challenges that lie ahead. We begin by examining the characteristics of a regime. We link this concept to that of investment governance via a series of questions that a board of trustees or investment committee can ask regarding its own policies and practices for the endowment of the institution over which it has authority. Finally, in the appendix, we place the shift in regimes occurring now in its historical context, analyzing key characteristics of the four regimes that have characterized the last 49 years.

What is a regime?

We've defined regimes in terms of both economics and politics, yet we claim a more long-lasting and structural role for regimes than the simple rotation of political parties in office or the ups and downs of economic cycles. Put simply, for our purposes, a regime can be defined as the overall structure of the political/economic (and, indeed, sometimes social) environment, which sets the limits of what's possible for long-term investors to achieve. In this sense, regimes themselves operate within the larger rules of the regulated market economy that characterizes modern developed countries and are subject to changes in that larger environment; yet they're not blindly reactive to those rules and sometimes can struggle to transcend or break free of them.

This concept isn't original; noted economists and commentators have in many places defined the regimes that have prevailed over the last century. For the most part, however, their analysis has been focused on the effect of regimes on economic and market-related measures, such as growth in gross domestic product (GDP) or the level of the S&P 500 rather than on the limits of the possible for institutional investors.

Discerning the regime

While it may be possible to identify the key characteristics of the regime in which we're operating, in practice it's frequently not until the very end — or perhaps even in hindsight — that most participants can truly view the world they've been living in. Moreover, being able to identify a given regime correctly and clearly isn't the same as being able to take action to profit from it. Each regime bears within itself levels of volatility and opacity that, viewed through the eyes of contemporaneous observers, may obscure the true nature of the investment landscape.

Yet it's important that fiduciaries attempt to discern what regime they inhabit. An informed opinion at the level of an institution's investment committee about regime is arguably as important as the individual asset classes and investment strategies chosen for its target portfolio. Put another way, if a regime describes the boundaries of what's possible at a given point in time, the roles of investment policy, portfolio construction and manager selection can become much better defined.

Regimes and governance

For this reason, a good practice for an investment committee should be an annual review of the regime. This isn't the same as an annual economic forecast, though it may share some elements of the latter. A good time to schedule such a review might coincide with the committee's (or board's) annual planning session or retreat. The idea would be to set the institution's purpose, needs and capabilities in the context of the prevailing regime, with the goal of creating an investment program that's both authentic and achievable.

Here are questions that a regime analysis might address:

What's the strategic purpose of the institution, and what's the role of the endowment in supporting it?

The explicit alignment of the institution's endowment with its mission, and the degree of operating budget support required from the endowment, are the beginning points for any analysis of the regime. An institution that's less dependent on its endowment may still be vulnerable to the forces shaping the regime through their influence on factors such as donations or (for educational institutions) tuition flows.

How does the institution define risk?

Modern Portfolio Theory, which forms the theoretical basis for much of contemporary investment practice, has identified risk with volatility of returns, but other types of risk can be at least as significant. The inquiry should include these factors in order to ascertain the extent to which circumstances, such as the following, might be triggered or exacerbated by a change in regime:

- Unacceptably large declines in the market value of the endowment, followed by extended periods of recovery during which the endowment is unable to provide the expected support to the institution
- The inability to maintain sufficient liquidity to meet the institution's ongoing mission or operating budget obligations in the event that, during bear markets, investments can't be sold at or near their expected value and credit isn't available
- Insufficient understanding of the behavior of the portfolio under stress, leading to unexpected losses

What's the intended direction of fiscal policy at the macro level inside and outside the U.S.? Of monetary policy?

This line of inquiry addresses the growth potential of the economy, which is a key driver of equity returns, the cost of money and the potential returns from being a lender. The questions asked should address, for example, the appropriate portfolio balance between equity and fixed income, and an attempt should be made to arrive at an opinion regarding liquidity conditions as they might affect the health of the institution and its endowment.

What political and social factors exist that influence the investment environment?

Legal and regulatory structures in a democracy are frequently responses to changes in the society itself. The acceptability of investment practices such as the exclusion of certain types of investment from the portfolio; the integration of environmental, social and governance standards into investment analysis; and the permissibility of impact investments that combine economic and mission-related goals are all factors that can affect the content and return profile of an investment portfolio. Fiduciaries should strive to be aware of the stability of the ground on which they stand in order to be able to make decisions that are seen to be both appropriate and prudent.

What relevant factors exist affecting international relations, global trade and international investment flows?

While regimes can persist for a considerable time, they can also undergo fundamental alteration without much warning. For example, the Biden administration's approach to trade and diplomatic arrangements may lead to significant alterations in the opportunities, risks and potential returns available to long-term investors. A clear-eyed examination of these changes should be part of the annual regime analysis, even if the conclusion is that any changes will be marginal.

How do the interactions of these factors favor or impede successful investment in the broad asset groups of public and private equity in the U.S., developed and emerging countries, domestic and international fixed income, real assets such as commodities and real estate, and hedge strategies?

This question requires an examination of the potential risks and returns associated with each asset class or investment strategy. While technical analysis can be helpful, the final purpose should be to enable fiduciaries to understand the limits of what they can expect from their actions as investors and to be able to set their goals accordingly.

What factors could lead to a change in the current regime? How can those factors be assigned a weighting as to their relative probability?

All regimes eventually come to an end. It's important for fiduciaries to strive to understand how the regime they currently inhabit could change or terminate and, possibly through analysis of various alternative scenarios, how their institution might encounter benefit or harm.

It's obviously not possible to arrive at a set of firm conclusions about all of these matters. In fact, it could be argued that a certain humility in the face of these questions is one of the requirements for success in this exercise. It's beyond doubt, however, that it's better to have an informed opinion, albeit a qualified one, about regime issues than to ignore them entirely.

Fiduciaries should, in particular, try to reach an opinion about the relationship between investment results and inflation, since it's estimated that around two-thirds of the costs of nonprofits are human resources-related items such as salaries and benefits. An investment strategy that contemplates mission support but can't maintain the purchasing power of the endowment after those expenditures may not be sustainable for long.

Conclusion

The question of what regime we are in is, at any given time, a challenging one to answer. It's very hard to see the structures of markets and historical forces from close up. But that difficulty doesn't excuse us from making the attempt. In particular, with endowed institutions overwhelmingly making use of consultants and external managers, both of whom employ skilled analysts and economists with access to sophisticated quantitative models, an annual review of the regime seems a relatively simple request. The benefits of such a process, even if imperfectly performed, appear plain: a deepening of the understanding of fiduciaries and asset owners, who are charged with prudently optimizing the use of the resources over which they have authority; and of the larger forces at work in the world, dictating what is and isn't achievable.

Appendix: Regimes since 1973

As the following examples demonstrate, over the last 49 years — within the working lifetimes of many fiduciaries — four distinct regimes can be discerned. If we begin our analysis with the oil embargo imposed in 1973 by the Organization of the Petroleum Exporting Countries (OPEC), it will be sufficient to set out the regimes that have prevailed since then and to illustrate the way in which regimes can constrain, or liberate, asset owners and fiduciaries.

1973 – 1982: Stagflation

For the U.S., which in 1973 was preeminently an economy driven by cheap fossil fuel-based energy sources, the decision by OPEC to place an embargo on oil sales changed the nature of many economic and social relationships, and led to a continuing political crisis that lasted through the remainder of the decade. Crude oil prices quickly quadrupled, and the fact that U.S. domestic oil production had been declining meant that it was very difficult to replace the missing OPEC imports. Energy shortages around the country resulted in lines at gasoline stations, the imposition of a lower national speed limit of 55 mph and even the declaration of year-round daylight saving time in 1974 – 75. The high cost of gasoline created an opening for Japanese automobile manufacturers, which, with their smaller and more fuel-efficient cars, rapidly took market share from the established U.S. companies with their less efficient vehicles.

The more durable result of the embargo was a permanent increase in the price level of energy. Even after the embargo ended, oil prices didn't come down. This increase in the price of a key production input, unaccompanied by corresponding increases in productivity, led to a general price inflation across the economy. Labor costs, in particular, rose, since nearly one-quarter of the national workforce belonged at that time to unions whose contracts frequently contained automatic cost-of-living escalation provisions. This spiraling increase in costs slowed economic activity throughout the decade. The word coined to describe this situation — stagflation — perfectly set forth the dilemma facing institutional investors. Low growth suppressed equity returns, while low to negative real interest rates, combined with persistent inflation, made bonds a bad bet.

During this period, endowed institutions' portfolios largely consisted of U.S. stocks and bonds; international investing wasn't yet a common practice, particularly since each country in Europe still had its own currency, and the mechanics of currency hedging were cumbersome and expensive. Real assets such as commodities and real estate performed comparatively well, but commodities in particular were regarded as speculative assets for traders rather than as inflation hedges, and institutional real estate investment didn't form a large part of most endowment portfolios at that time.

More fundamentally, inflation as a force in investing was poorly understood. Investment policy was still largely based on old trust law principles, under which fiduciaries were charged with preserving the nominal value of invested capital and distributing only interest, dividends, rents and royalties. The implicit belief underpinning investment practice was that prices were stable and that capital returned at the maturity of a particular investment would have the same purchasing power as when the investment had first been made, many years before. Total return investing, whereby capital appreciation was included in calculating investment returns, was in its infancy; indeed, the Uniform Management of Institutional Funds Act (UMIFA), which expressly allowed total return investing, was only introduced by the Uniform Law Commissioners in 1972. Viewed in terms of regime, therefore, the stagflation period was one in which it became extremely difficult for endowed nonprofits, pursuing the traditional investment strategies that were then prevalent, to achieve their twin goals of mission support and maintenance of purchasing power.

1982 – 2008: Deregulation and expansion

The stagflationary regime was brought to an end in large part by the actions of the Federal Reserve, which, under the leadership of Chairman Paul Volcker, changed expectations of future higher inflation by raising interest rates. The federal funds rate reached 20% in June 1981, a level previously unseen in the U.S. Inflation finally began to fall, permitting interest rates to be lowered gradually. This set the stage for a prolonged secular rally in the bond market. Lower borrowing costs, together with deregulatory initiatives that were followed by both Republican (Reagan, G.H.W. Bush and G.W. Bush) and Democratic (Clinton) administrations, combined with deficit spending at the governmental level to buoy the stock market. A collapse in private-sector union membership to less than 7% of the workforce by the mid-2000s weakened the link between inflation and wage demands, at least in industry.[1] This regime also saw the increasing availability of new financial tools and products, by which institutional investors were able to acquire exposures and mitigate risk in ways not previously possible. Indeed, some commentators claimed that a golden age of self-regulating and ever-increasing prosperity had arrived, particularly when, after the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union in 1991, it seemed as if the major geopolitical challenges facing the market-based developed economies had been permanently vanquished.

While the deregulatory regime saw a number of severe market declines, notably in 1987, 1994 and 2000, prompt action by the Federal Reserve and other central banks served to mitigate the ensuing damage so that truly serious and prolonged recessions were avoided. This regime was therefore a very benign one for endowed nonprofits, characterized by expanding investment opportunities and increasingly sophisticated risk management tools. Despite the market volatility, equity allocations did very well, and bond investors were rewarded by a constantly declining interest rate environment, which supported the value of their portfolios. In some respects, the use of interest rate policy to promote recovery from stock market corrections led to a belief — whether accurate or not — that the power of global central banks was such that permanent damage from market corrections could more or less always be avoided.

2008 – 2021: Collapse, convalescence and pandemic

The causes of the global financial crisis of 2008 – 2009 will be debated for a long time, but all agree that the effect on investment portfolios and the real economy was catastrophic. In a repeat of the famous bank credit-led Panic of 1907, financial institutions lost confidence in each other, credit and bank liquidity disappeared, and the stock market collapsed in a series of waterfall sell-offs that exacerbated investor anxiety and concern for the soundness of banks, brokerages and other financial institutions. In the end, the use by Federal Reserve Chairman Ben Bernanke of unorthodox methods to support the banking system and the credit markets was widely held to have avoided a global depression.

These methods included outright purchases of financial assets in market operations, which caused the Fed's balance sheet to balloon to many times its pre-crisis size. Interest rate policy was also not neglected, with real rates maintained at or below zero in an effort to encourage a revival in economic activity.

On the positive side, this set of policies achieved its twin aims of supporting recovery in the equity and residential property markets and of encouraging borrowing and lending in the credit and bond markets. The cost, however, was a distortion in relationships between risk and return in many investment strategies that affected institutional investment portfolios profoundly.

To take one example, public equity markets bottomed out in March 2009 and began a prolonged, if erratic, recovery that persisted up to the onset of the global COVID-19 pandemic in early 2020. Bond markets, too, benefited from the zero-to-negative interest rate policy, effectively extending the rally that had been begun by Volcker nearly 30 years previously.

Other strategies, however, performed less well. Many hedge fund strategies, which depended on specific risk-reward relationships for their success, saw returns shrink or disappear entirely in the supportive environment created by the central banks. Similarly, venture capital and private equity strategies, which depended on the availability of liquid markets to realize their returns via initial public offerings (IPOs) and merger activity, were unable to return to their investors the capital that had been earned because of the tight IPO and merger markets that prevailed during the first years of the recovery.

For endowed institutions, therefore, the convalescence regime was one in which more-diversified portfolios frequently performed less well than those that were less well diversified, and U.S. domestic assets performed better than non-U.S. investments. This result, which contradicts investment theory, was compounded by the general outperformance of index strategies over active management during this period. In an environment in which most economists predicted that GDP growth, and market returns, would for several years continue to be lower than in the past, it became increasingly difficult for fiduciaries to justify paying the higher fees charged by active investment managers, whether in traditional or alternative investment strategies. A successful investor at the outset of this regime would simply have indexed the entire portfolio, avoiding non-U.S. and alternative investments and dividing the allocation in a very traditional way — for example, 60% to U.S. equities and 40% to U.S. bonds. Such a portfolio would have handily outperformed many more-diversified, actively managed portfolios over the entire period.

The global COVID-19 pandemic, which in 2020 upended society and led to high unemployment and a sharp decline in equity markets, provoked a set of coordinated responses by governments and central banks around the world, including, in the U.S., direct financial support for those who had lost their jobs, loans convertible into grants to encourage businesses and nonprofits to retain their employees, and payments to state and local governments to replace lost tax revenues.

The resultant surge in the money supply led to extraordinary equity returns for 2021, while bonds were also strong performers in an environment of low to negative real interest rates. The possibility of a resurgence in inflation was debated, but given the experience of the previous 12 years, many observers failed to predict how strong or persistent inflation would prove to be when it arrived.

On the trade front, the continuation by U.S. President Joe Biden of many of the economic policies pursued by his predecessor, Donald Trump, surprised numerous commentators, implying a very supportive fiscal environment, with an emphasis on public works and infrastructure spending, and attempts to increase employment among lower-skilled segments of the workforce. In addition, both administrations characterized themselves as being intent on pursuing an "America First" trade policy, in which imports would be discouraged and exports encouraged, possibly at the expense of long-standing tariff structures and global trade agreements — a feature that would become more prominent in the regime that was to follow.

2022 – ?: Disinflation, deglobalization and geopolitical stress

The turn of the year saw an abrupt change in regime, characterized by factors that were almost the mirror image of those that had prevailed for the previous 12 years:

- Double-digit inflation, accompanied by surges in demand that placed stress on global supply chains, by worker demands for higher wages and by sharply higher energy prices brought about by Russia's invasion of Ukraine in February 2022
- Higher interest rates, led by belated increases in short-term rates by many global central banks in an effort to stem inflation
- Shrinking of central bank balance sheets and therefore of the money supply, also with the aim of reducing inflation
- A very tight labor market as some workers chose to retire or withdraw from the workforce
- Decreasing global integration, exacerbated by geopolitical tensions between the U.S. and China
- A major conflict in Eastern Europe with global repercussions

In this environment, it's arguable that investment strategies that were rewarded in the previous regime may not have such success in the current regime.

For endowed institutions, this regime has already meant the end of the bull market in bonds, as interest rates are rising sharply. It may also increasingly require a reconsideration of some of the key (if unspoken) tenets of endowment investing, which include the assumptions that markets will remain relatively open, that globalization and increased trade will continue to be the stated policy of leading nations, and that investments made outside the U.S. will be able to be repatriated with relatively little friction in the way of additional taxes or costs.

[1] Public-sector union membership remained quite robust, at over 35%, during that period.