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The return on governance

Good governance could deliver a higher return and more resilience in endowments and foundations portfolios

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Introduction

Strong investment governance helps make a tangible contribution to portfolio outcomes, particularly over the long-term time horizons of endowments and foundations (E&F) portfolios.

The opening years of the 2020s have delivered a wave of interconnected challenges for investors, with the combined impact of COVID-19, the war in Ukraine and rising interest rates driving widespread regime change across the global economy and financial markets. From high inflation and supply chain disruption to banking crises, the complexity of today's backdrop has brought new tests for investors.

In this environment, investment committees and trustees managing portfolios on behalf of E&F organizations are focusing much of their energy on portfolio construction and the risk-adjusted returns expected from portfolio allocations. This "return on investment" is front of mind for many organizations.

We believe that generating a "return on governance" can be particularly effective for E&F portfolios — from charities and foundations to faith-based organizations.

In their bid to maximize returns, however, organizations risk overlooking the potential "return on governance"; namely, how good governance practices can potentially help enhance returns and better manage risk over the long term.

From our work with global investors — from endowments and foundations to sovereign wealth funds and pension schemes — we know that good governance enables portfolios to respond to changing circumstances and market movements. This flexibility mitigates the risk of being caught off guard by adverse events and supports organizations seeking to capitalize on investment opportunities through periods of market upheaval.

We believe that generating a "return on governance" can be particularly effective for E&F portfolios — from charities and foundations to faith-based organizations — given the long-term time horizons that typically characterize the objectives of this group of investors.

We were interested in understanding — and quantifying — what a "return on governance" could potentially constitute in the context of a long-term E&F portfolio, and we explore the implications of that in this paper.

Executive summary

The return on governance

We believe it is prudent for E&F organizations to consider the long-term value-add of governance frameworks in managing portfolios.

We believe that a robust governance model can:

- **Help align liquidity decisions within portfolio allocations to a long-term horizon**
- **Expand diversification of the portfolio across asset classes to manage risk**
- **Help enable effective rebalancing**

In combination, these three core components enhance organizations' flexibility to navigate regime change and geopolitical events in markets.

In this paper, we quantify the estimated "return on governance" derived through the implementation of these three core components.

Based on the expected returns of model portfolios in relation to Mercer Investments' long-term (10-year) capital market assumptions, our proprietary analysis suggests that, in the aggregate, these frameworks contribute 115 bps to annual performance.

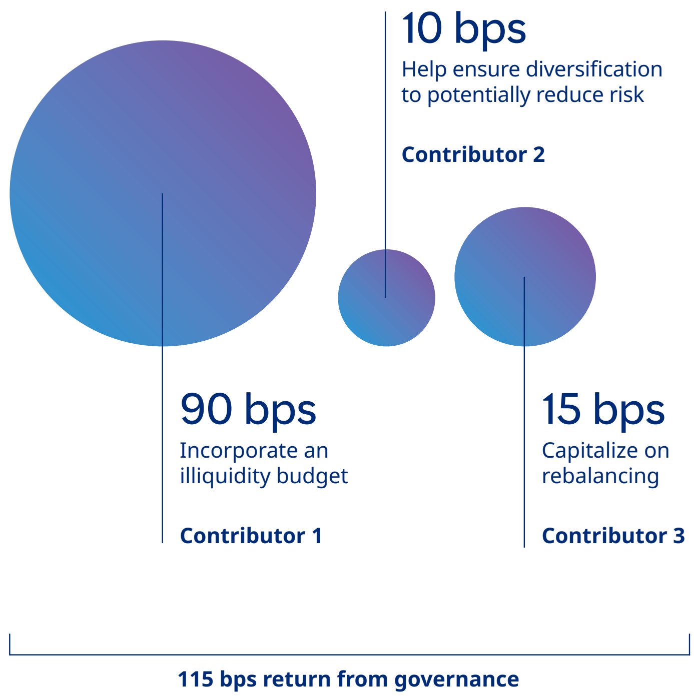
This is not to say that plans and organizations with strong governance policies and procedures in place can expect to achieve an additional 115 bps each year. Rather, organizations that have yet to implement these frameworks risk missing out on an estimated 115 bps of performance annually.

In the context of an annual return target of 6%–7% (relative to a 4%–5% spending rate for a typical endowment portfolio, on top of long-term inflation), 115 bps annually is significant. For a $100 million plan, this would be in excess of $1 million in value per year.

Compounded over the course of a time horizon of 10, 20 or 30+ years, this expected annual "performance buffer" becomes even greater.

Illustrative return on governance*

Impact of contributors



Contributor 1

Incorporating an illiquidity budget for long-term growth

Contributor 2

Diversify to build resilience and reduce risk

Contributor 3

Capitalize on opportunities by rebalancing efficiently

* As of August 1, 2023. Expected returns are derived using Mercer's Capital Markets Assumptions. This is shown for informational and illustrative purposes only. There are no guarantees that Mercer assumptions are or will be accurate. Actual performance is likely to vary. See Important Notices for additional information.

Events of the recent past have prompted many organizations to reassess portfolio exposures.

Events of the recent past have prompted many organizations to reassess portfolio exposures, understand underlying geopolitical risks more accurately and reflect on their ability to respond to market events.

Through the market turmoil and underperformance catalyzed by Russia’s invasion of Ukraine in 2022 or the banking crisis in the first half of this year, risk-management policies and procedures have become a priority for investment committees and boards.

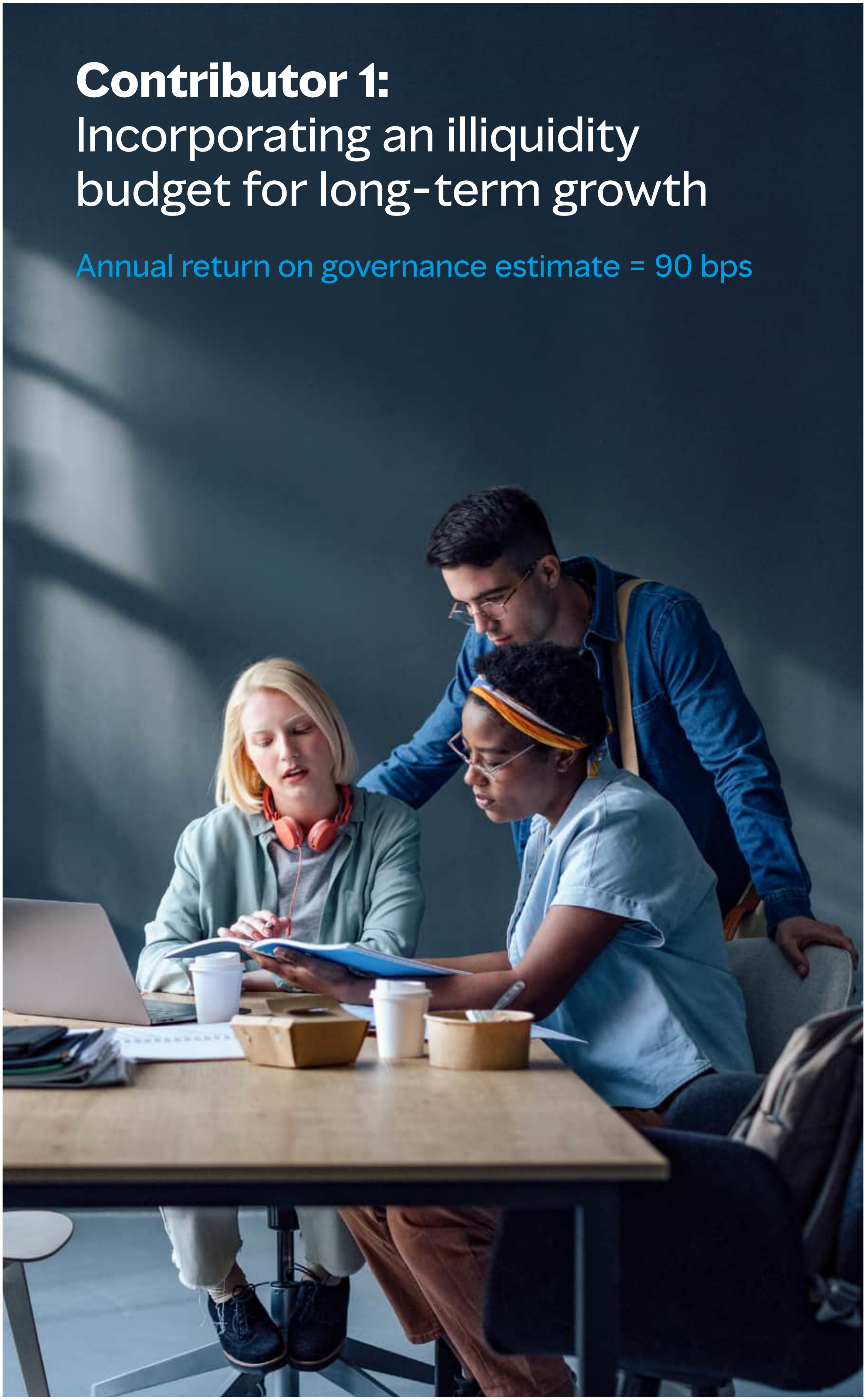
Of course, governance challenges evolve over time. In establishing a policy, many organizations seek our guidance on translating asset-allocation decisions into policy ranges. But once these ranges are established, it is not simply a case of “set and forget,” particularly over extremely long-term investment horizons. Organizations need to ensure rebalancing policies can be structured to take advantage of market dynamics as opportunities arise. Plans need adequate flexibility to manage around these ranges.

A recent market dynamic has provided a challenge for E&F organizations when it comes to private market allocations versus target after a public market drawdown. Known as the “denominator effect,” the declining value of (in some cases) large public equity allocations has hit total portfolio values, causing many private markets allocations to overshoot policy targets. Even organizations with sophisticated governance structures have required flexibility to manage through these complexities.

We hope that this paper proves useful for organizations reexamining their governance capabilities, with a view to helping enhance resilience through regime change in markets.

Contributor 1: Incorporating an illiquidity budget for long-term growth

Annual return on governance estimate = 90 bps



Allocations to illiquid assets can help provide compelling risk-adjusted returns, the potential for greater diversification, an illiquidity premium and potential protection from public market shocks.

By allocating a portion of portfolios to illiquid assets, we believe investment programs can better support their strategic objectives over the long term.

In many cases, E&F organizations are investing to meet annual cash and/or spending requirements, delivered by capital growth of the portfolio. With these objectives in mind, portfolios may benefit from the return premium, downside protection and diversification benefits derived from taking on illiquidity risk.

For some organizations, it may be useful to consider the question of “opportunity cost”: the cost of not allocating to illiquid or alternative assets when you have the ability to.

A strong governance model allows these questions to be asked around ability and opportunity cost of investments in certain asset classes, such as illiquid assets. If organizations are not considering the opportunity costs, they may establish programs that are not optimal from a risk-and-return standpoint.

To estimate the opportunity cost of not allocating to the likes of private equity, credit, real estate or hedge funds, we analyzed the long-term relative expected performance of two model portfolios based on our long-term (10-year) capital market assumptions. The first portfolio is a baseline representing a typical endowment foundation model, constituting a 60/40 equity-fixed income split. The second (Portfolio 1) includes a greater element of diversification with less liquid assets.

We estimate that incorporating illiquids within the governance model constitutes 90 bps annually — three-quarters of the overall 115 bps return on governance we estimate good governance can deliver each year — by supporting an increase in risk aligned with the risk tolerance of the organization.

Comparison of the expected returns of the baseline model portfolio and Portfolio 1 showcases the potential value created by trading a proportion of core public equity and fixed income assets for illiquid assets.

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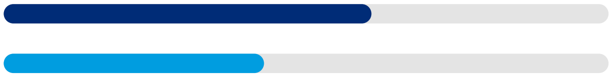
Example 1*

Typical endowment foundation model (baseline)



- 60% Global equity
- 40% Global fixed income portfolio

Portfolio 1

- 35% Global equity
- 25% Private equity
- 25% Global fixed income
- 15% Diversified hedge funds

Typical endowment foundation model (baseline)

5.6%	11.9%
Illustrative expected return	Illustrative expected risk

Portfolio 1

6.5%	12.8%
Illustrative expected return	Illustrative expected risk

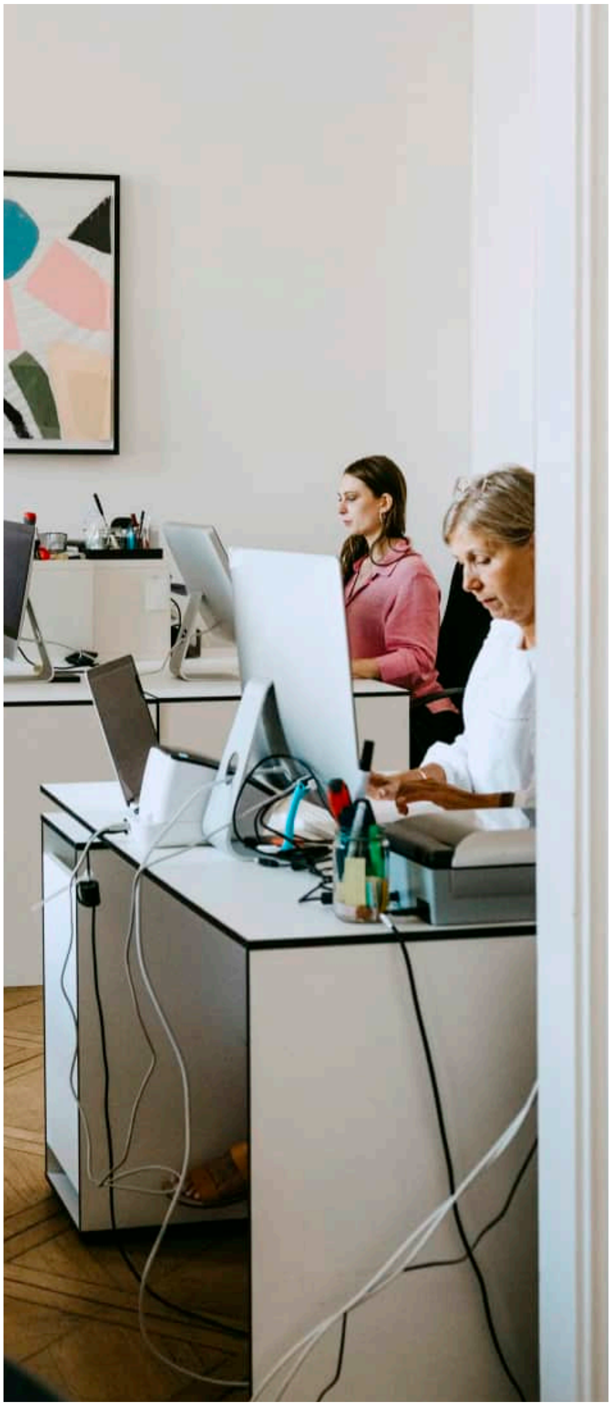
Our analysis does not account for the operational and logistical needs of building an illiquid allocation, which will vary depending on the scope and specifics of the allocation. The potential for above-median manager performance from funds has also not been factored in. The 90-bps annual premium delivered by a governance model that incorporates illiquid allocations is based on the median expected returns over a 10-year period, not accounting for the potential for manager alpha.

Key points

Potential benefits of implementing illiquid allocations

Beyond illiquidity premium, illiquid allocations may offer a degree of downside protection against the day-to-day volatility and economic cyclicality of public markets, supporting portfolio resilience to rising interest rates, persistent inflation and short-term market volatility:

- Real asset allocations such as infrastructure and real estate tend to generate revenues tied to inflation, whereas floating-rate private debt can serve as a long-term inflation hedge.
- In the private equity space, managers generate returns through their ability to transform the condition and value of a portfolio company at the time of acquisition or investment to something discernibly better at the point of exit, sale or continuation in another fund vehicle. In doing so, managers deliver a value-add premium for investors.



Contributor 2

Contributor 2: Diversify to build resilience and reduce risk

Annual return on governance estimate = 10 bps

We believe that by expanding diversification to incorporate a broad range of asset classes, organizations can potentially reduce risk across portfolios.

Having incorporated illiquid exposures within the portfolio, we encourage organizations to consider the potential benefits of diversification more broadly. Organizations can strengthen governance by ensuring an optimal level of diversification within the constraints of the organization, such as cash needs. Put another way, **being open to asset-class diversification is essential to good governance.**

Generally, organizations with greater cash requirements (as a percentage of the portfolio) are more conservative, with limited desire for shorter-term volatility. Some diversification tools are better than others when thinking about cash-flow needs in the near term or the ability to accept short-/intermediate-term volatility.

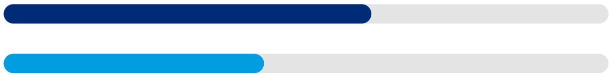
Our analysis indicates that expansion of diversification programs — for example, by increasing strategic allocations to assets like real assets, inflation-linked bonds and additional multi-asset credit strategies that all offer downside and/or inflation protection, as featured in Portfolio 2 in our examples — can expect to deliver material risk reduction based on our forward-looking assumptions.

Extending our analysis to compare the relative performance of Portfolio 2, we showcase the potential impact of advancing the diversification program. Although Portfolio 2 only delivers a marginal benefit (10 bps), in terms of expected return, the additional diversification of this portfolio has a material impact of 380 bps in reducing risk.

Organizations with goals to implement diverse programs will be affected by a range of factors, including the availability of products in asset classes and portfolios' liquidity requirements. Investment programs designed to outperform benchmarks by defined margins may also employ very different strategies, managers and allocations to those seeking to minimize performance deviations from set benchmarks.

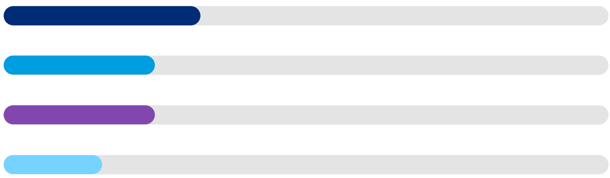
Example 2*

Typical endowment foundation model (baseline)



- 60% Global equity
- 40% Global fixed income portfolio

Portfolio 1



- 35% Global equity
- 25% Private equity
- 25% Global fixed income
- 15% Diversified hedge funds

Typical endowment foundation model (baseline)

5.6%	11.9%
Illustrative expected return	Illustrative expected risk

Portfolio 1

6.5%	12.8%
Illustrative expected return	Illustrative expected risk

Portfolio 2
Unconstrained growth reference portfolio**

6.6%	9.0%
Illustrative expected return	Illustrative expected risk

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** A portfolio created by Mercer including a broad range of asset classes and diversified investment approaches.

We encourage all organizations to consider the material risk-reduction benefits of an expansion of diversification programs regardless of their return objectives. In many cases, opportunities exist to reduce risk without sacrificing return by adding additional asset classes.

Although organizations' ability to offset risks through diversification will vary meaningfully according to their specific circumstances, we recommend that committees quantify and rate the risks to their organizations in terms of potential impact.

Key points

The potential benefits of diversification can include:

1. Lower overall risk profile, without affecting expected returns
2. Potential protection of value during drawdowns
3. Differentiated drivers of return, which may smooth returns over time
4. Taking advantage of the investment opportunity set beyond traditional stocks/bonds (on this element in particular, robust governance around the selection and oversight of managers can help support effective alpha generation over time)

Contributor 3: Capitalize on opportunities by rebalancing efficiently

Annual return on governance estimate = 15 bps

Rebalancing may help enhance returns but is most important as a tool for risk control and mitigation. Declining markets will ultimately trough and rebound. Without rebalancing, portfolios may struggle to recover lost value.

When an asset class moves beyond a specific range, it may cause the expected return and/or risk of the portfolio to diverge from its strategic intentions. This is because organizations' governing policies generally provide asset-allocation ranges for each asset class within the portfolio around a strategic asset-allocation set in pursuit of specific return and risk targets.

The adoption of a governing policy imposes a fiduciary obligation to maintain the investment structure of the portfolio in line with the terms of the investment policy statement (IPS). Industry best practice requires periodic rebalancing toward asset-allocation targets. Actual allocations moving outside the maximum and minimum ranges should be addressed promptly, unless otherwise provided for in the IPS.

Historically, rebalancing capabilities have contributed most significantly to portfolio returns through periods of market drawdown.

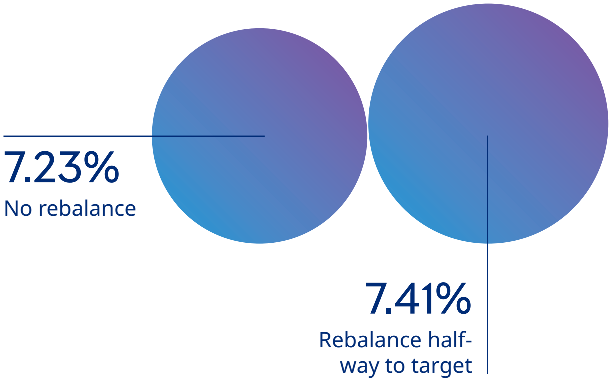
We believe effective rebalancing that adheres to asset-allocation targets and ranges is a core component of good governance, helping to deliver both long-term return and risk benefits for portfolios.

However, in an increasingly complex market environment, flexible asset-allocation targets and policies that enable nimble, timely rebalancing have become key tools for organizations dealing with unexpected market changes. It is, of course, essential for organizations to consider the rebalancing process in the context of the costs and risks involved.

Historically, rebalancing capabilities have contributed most significantly to portfolio returns through periods of market drawdown.

Our analysis suggests that rebalancing halfway to target is most effective.

Using a long-term starting point of 1990, we assessed a 60/40 portfolio that was rebalanced monthly halfway to target. The 60/40 portfolio produced a return of 7.23% over the course of the period, and the 60/40 portfolio that was rebalanced halfway to target produced a 7.41% return (assuming a 10 bps transaction cost and both net of fees).



This indicates a premium for rebalancing halfway to target. We estimate that effective rebalancing provides a return on governance of 15 bps.

By establishing and implementing a rebalancing policy, organizations provide a base level of discipline in response to potentially extreme market events and stressed scenarios.

Having a rebalancing policy in place is non-negotiable, with the time to implementation warranting particular consideration.

Timely implementation is essential to effective rebalancing

To optimize the effectiveness of rebalancing policies, organizations must have the flexibility and infrastructure to assist with timely implementation (for instance, monthly or quarterly).

Some investment committees require committee approval for all rebalancing, which can present major delays to timely implementation. In these scenarios, opportunities that require implementation in a matter of days may take weeks or months to action.

When organizations have dedicated investment staff, a good governance model would authorize rebalancing within particular ranges without full committee approval. Authority to implement policies may also be delegated to an investment consultant or a subgroup of the investment committee.

In our view, having a rebalancing policy in place is non-negotiable, with the time to implementation warranting particular consideration.

Key points

When rebalancing, every day counts

The most important factor in determining the effectiveness of rebalancing policies is time to implementation, particularly through periods of market stress as the chart below illustrates.

As the below market events indicate, the case is clear for selling at the bottom and trying to get back into the market at the right time. Crucially, though, the time to recovery or bounce back in equity markets can happen within a matter of days and weeks, making the speed of response even more important. We note that it is incredibly hard to time when markets hit a bottom (and often impossible), but in many cases, organizations have no opportunity to capture this upside if the rebalancing policy does not allow for trading efficiently and in a timely manner.

	COVID-19	Russia/Ukraine	SVB/Regional banking distress
Event date	3/11/2020	2/19/2020	3/10/2023
Start of selloff	2/24/2022	2/16/2022	3/6/2023
Duration of selloff (trading days)	24	15	6
Duration to recover prior level (trading days)	101	11	14
Size of selloff (1%)	-33.8%	-6.7%	-4.7%
One week from bottom	17.4%	2.3%	2.5%
Three months from bottom	40.7%	-0.9%	13.8%
12 months from bottom	77.8%	-2.7%	N/A

Source: Bloomberg, Mercer Analysis. Data as of June 23, 2023.

* A selloff is deemed to be the selling of a large enough volume of securities within a short time to cause a corresponding dramatic decline in pricing.

Special focus: Resilience to geopolitical risks

Special focus

Throughout the course of this paper, we have estimated the return on governance contributed by three core components of an effective governance model.

Some of the biggest risks that organizations' governance models need to manage and respond to are geopolitical. Given that the impacts of geopolitical events are idiosyncratic, short-term and specific to events as they unfold, it would not be appropriate for us to estimate a comparable return on governance in relation to the ongoing management of these geopolitical risks.

However, the three components of governance we have considered are instrumental to organizations' crisis-response capabilities. Steps to build illiquid allocations, expand diversification and reduce risk should give organizations confidence through periods of market crises.

Managing geopolitical risks

Through diversification away from equities, organizations reduce their portfolios' direct equity risk to geopolitical events. Analysis of the impacts of a range of market shocks indicates that the median shock to the equity market is a down 6.6% net return for equities.

Example 3*

Typical endowment foundation model (baseline)

- 60% Global equity
- 40% Global fixed income portfolio

Portfolio 1

- 35% Global equity
- 25% Private equity
- 25% Global fixed income
- 15% Diversified hedge funds

Typical endowment foundation model (baseline)

5.6%	11.9%	**0.6%**
Expected return	Expected risk	**Equity beta**

Portfolio 1

6.5%	12.8%	**0.7%**
Expected return	Expected risk	**Equity beta**

Portfolio 2
Unconstrained growth reference portfolio**

6.6%	9.0%	**0.4%**
Expected return	Expected risk	**Equity beta**

Our model diversified portfolio has an equity beta (sensitivity to change in the equity market) of 0.4% — 33% lower than a traditional 60/40 portfolio. By having a lower equity beta, organizations tend to enhance their resilience to equity market shocks.

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** A portfolio created by Mercer including a broad range of asset classes and diversified investment approaches.

Key points

Enduring sudden shocks

In our view, investors can build potential portfolio resilience to sudden shocks in the following ways:

- Maintain geographical, sector and return-driver diversification in portfolios.
- Look to build potential portfolio resilience through strategic allocations to downside protection assets, such as sovereign bonds, inflation-linked bonds and gold.
- Some managers may have the necessary skillset and flexibility to navigate these kinds of crises through dynamic and opportunistic risk expression and a more robust risk management toolkit.

Conclusion

Organizations should aim to build investment programs that meet their needs in the most efficient way possible.

To help achieve this efficiency, committees and staff should explore all ways to improve and optimize the management of these assets, **including qualitative governance strategies**. By employing good governance — and the three contributors analyzed above — organizations may achieve **stronger investment results while prudently managing risk**.

During strong markets, good governance ensures the program does not leave “money on the table” in the form of portfolio returns. Through market downturns, good governance models can help to ensure market value protection and provide all parties with peace of mind that the program has the appropriate level of risk to weather storms.

Building good governance models into the investment process unlocks real value potential for your organization.

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