Investing is like a marathon

We are certainly living in uncertain, if not unprecedented times. But when it comes to markets and investing, we are in a marathon, not a sprint. During periods of market turbulence and dislocation, portfolio diversification is especially critical in absorbing volatility spikes. In times like these, we must avoid looking back and focus on looking forward and prepare for a prolonged period of heightened volatility ahead.
We are certainly living in uncertain, if not unprecedented times. But when it comes to markets and investing, we are in a marathon, not a sprint. During periods of market turbulence and dislocation, portfolio diversification is especially critical in absorbing volatility spikes. The first quarter of 2020 saw the greatest decline in global equities since the 2008 financial crisis. But while we have seen capitulation in some markets (price-to-book ratios are back to 2008 levels in Asia, including Japan), globally valuations are still well above the troughs touched during the global financial crisis (GFC). While comparisons are always difficult to make, there is room for asset prices to fall further. We remain conservative in our positioning, staying underweight equities. On the fixed income side, we emphasise quality more than ever, preferring asset-backed versus cashflow-backed debt securities.

On the bright side, banks are better capitalised today and not as extensively leveraged as before the GFC. But they are still exposed to the great challenges now facing their corporate and retail clients due to virus-induced recession. Banks can provide the channel for the Federal Reserve’s support measures to reach companies and individuals.

The key government-stimulus target today is to protect consumers so that as many as possible can be carried into the recovery when it arrives. This will limit damage to companies hit by the loss of consumer purchasing power. Corporate margins will suffer. Some companies will go bankrupt and unemployment will rise. This will slow down the recovery, requiring an even stronger fiscal response. Government regulation is set to increase, and we are already seeing pressure on companies to reduce dividend payouts. We could also see a fundamental shift in the economic paradigm away from an emphasis on profitability and towards one that favours labour.

Crises tend to expose and penalise the weakest links most severely. At a country level, we favour those with the fiscal and legislative strength to deliver adequate fiscal stimulus—the US, Germany and China. We also prefer exposure to those taking the appropriate measures to contain the coronavirus. Longer term, we are focused on distinguishing the winners from the losers in the wake of this crisis. We expect a number of equity sectors to fare well, including healthcare and internet. Infrastructure could also benefit from increased fiscal spending. As profitability declines, we can expect a rise in M&A, which could provide fertile hunting grounds for cash-rich private equity funds. We continue to favour private equity, which is also less sensitive to the current fire selling taking place in public markets.

In times like these, we must avoid looking back and focus on looking forward. More than ever, it is important to realise the benefits of remaining invested in difficult times.

“More than ever, it is important to realise the benefits of remaining invested in difficult times.”

We are focused on quality, low-leveraged companies, ones that avoid excessive regulation and that are best positioned to be self-sustaining through times of turbulence—the owners of their own destinies.
In a nutshell
How the coronavirus medicine has affected markets

Companies around the world have started cutting dividends to keep enough cash on their balance sheets to navigate through uncertain times. The message (at least implicitly) from governments in developed markets is that companies applying for financial support will have to forgo dividend payments. European banks’ dividends have been particularly hit as the ECB has urged them not to return cash to shareholders at least until October 2020.

The US Treasuries market suffered from a significant lack of liquidity in March. This was exacerbated by a feedback loop of forced sellers, especially from long-short strategies with extensive use of leverage. Thanks to the Federal Reserve’s increased purchases, market dislocation eased in the Treasury market. We expect this trend to continue as the Fed’s rapid purchases of securities from dealers’ inventories appeared effective in stabilising the market.
After the longest global expansion ever, the world economy now faces an unprecedented disruption indeed. The rapid spread of new coronavirus and the shutdowns rolled out across the world as a result have brought about changes to our outlook. In our central scenario, we expect an asymmetric, deep U-shaped recovery (asymmetric because the recovery could last at least six times longer than the period of contraction) across the Chinese, European and US economies. The result of this on world economic activity will be a deep global contraction of -4.1% in 2020, followed by the return of growth in 2021. The two main assumptions are:

1. One rather than two or three waves of the new coronavirus
2. A maximum of 60 days of containment measures

This outcome also relies upon adequate policy measures – both from central banks and government stimulus efforts. On the monetary policy side, having learnt from the 2008 financial crisis, central banks have already taken pre-emptive action, which is encouraging to avoid or minimise the liquidity and credit-crunch risks that would threaten a cascade of defaults, especially across the highly-leveraged corporate sector and some states (like Italy).

On the fiscal side, the US has already committed USD 2 trillion in fiscal spending, equivalent to 10% of its GDP. China has injected 5%. In the euro area, discretionary domestic measures and euro-wide initiatives should represent the equivalent of about 7% of GDP. This combination of monetary and budget policy will help achieve the deep U-shape we expect in our core scenario, to which we have assigned a 60% probability.

The depressed oil price will put substantial deflationary pressure on the US economy – an additional negative impact to the economy beyond the coronavirus and uncertainty around the presidential elections. Because of this, we expect a GDP contraction in the US of -7.7% in 2020, followed by a gradual rebound in 2021 as oil remains in the USD 20-25 per-barrel range through the rest of 2020 at least.

“We advocate staying invested in fundamentals in terms of economic trajectory and economic policy responses and focusing on the long term.”

Three other scenarios are possible for the global economy:

1. The best case scenario – 10% probability A soft U-shaped recovery should a Covid-19 treatment (e.g. chloroquine) provide hope for a short-term relief or broad testing relieve containment measures sooner than expected.
2. The downside scenario – 25% probability An L-shaped recovery without systemic crisis with a world GDP contraction of -7%.
3. The worst-case scenario – 5% probability An L-shaped recovery with a world GDP contraction of around -9% following a systemic crisis caused by a cascade of defaults, particularly in the corporate sector.

These are certainly challenging times, but remaining calm is essential. When it comes to investing, it is prudent to avoid panic and overreaction. Instead, we advocate staying invested in fundamentals in terms of economic trajectory and economic policy responses and focusing on the long term. Crises present the opportunity to take advantage of pricing dislocation when deploying capital in markets. Stay invested and stay diversified. We had the sharpest drawdown ever in equity markets, with the S&P 500 declining by about -34% in the space of four weeks from February-March. But a diversified portfolio that follows an endowment approach would have seen a drawdown of about half that magnitude. Diversification works!

With a looming world recession being met by a hefty policy response, investors should remember the value of staying invested and diversifying.
In a low-returns environment investors are flocking to private assets

With public equity markets in tailspin as economies shut down to contain the coronavirus, will private equity markets share the same fate? Overall, private-market valuation write-downs can be expected for some companies as early as the first quarter of this year, reflecting 2020 performance uncertainty and the devaluation of equity markets. On the transactions side, even while record transactions are being executed, some are being delayed or aborted by the application of material adverse change clauses.

Looking ahead, while each new crisis carries its share of uncertainties and turmoil, history has shown that market dislocations and sharp asset price corrections create investment opportunities: recession years tend to generate superior returns for the private equity asset class as a whole.

What asset-class specific risks does private equity face now?
Private-equity managers are currently assessing the immediate and potential future impact of the coronavirus outbreak on their portfolios on a company-by-company basis. Businesses are facing two key areas of risk: operational, which encompasses the negative impact on revenues, EBITDA or supply chain disruptions or financing, which translates into near-term liquidity difficulties or covenant concerns.

Companies exposed to travel, leisure, entertainment, corporate events and the energy sector face the highest operational risk. Private equity managers are currently working to implement protective actions wherever possible to address the operational risks identified.

The potential financing risk is assessed by the ability of capital structures to withstand a period of underperformance, carefully looking at the availability of liquidity, covenant headroom over the next six to 12 months and upcoming debt maturities. Thankfully, for the past few years, debt has been cheap and accessible, often available with no or few covenants, thus offering more headroom and reducing the burden on companies’ cashflows and default risk. At this stage, it seems that only a minority of companies face financing problems. For those few companies anticipating short-term liquidity issues or covenant breaches, private-equity managers are proactively working with lenders to address those matters.

How do you expect real estate assets to fare in the current environment?
While we expect the real estate space to experience adverse impacts from the Covid-19 crisis, the effects will likely be varied across property types and assets. Stabilised assets with established, longer-duration lease terms in place and “essential” live/work property types such as multi-family, logistics and offices should fare relatively well, at least over the near term.

“In a low-returns environment investors are flocking to private assets”
Other sub sectors like hotels and retail, whose business models face either secular or cyclical challenges, will suffer from the current dislocation. On the other hand, the recent decline in interest rates should provide some positive relief, having been historically conducive to price appreciation in property markets.

Everyone talks about the explosive growth in passive investing, but is private-asset investing the real dark horse in terms of asset growth? Indeed, private markets — composed of private equity, real estate, private debt, infrastructure and natural resources — are growing at twice the rate of ETFs, having tripled in assets under management over the last decade since the financial crisis. And there is a deeper point of comparison — or rather contrast — between passive and private asset investing. The performance of private assets is intrinsically linked to the advantages of active ownership. Notably, private ownership enables asset improvement through aligned incentives and flexible governance, and asset improvement directly creates value. In private equity today, asset improvement accounts for around 60% of its internal rate of return (IRR).

Beyond the current crisis, what are the key long-term industry trends and changes that you anticipate will impact private assets?

There are five areas of change that we are focused on that are already underway.

First is the broad expansion of private assets as companies remain private for longer and public companies delisting to go private are on the rise. Both private equity and infrastructure are asset classes in need of investment and this is where we see opportunities to create value as likely to grow.

The second is investor democratisation, with an increasing share of individual investors accessing private assets through intermediaries such as private banks, pensions, etc.

Third is tech disruption across the value chain, from deal sourcing to investment analysis through to client engagement, the automation of operations and beyond. In the real-estate sector, the disruption of e-commerce in retail could create attractive opportunities in logistics and data centres.

Fourth is the rise of Asia over the next five years, from both a fundraising perspective as well as an investment destination. Rising wealth and development in the region will make it increasingly central to the private asset industry.

And finally is the growing demand for sustainable investments. Indeed, today impact investing is predominantly in the private equity space and expected to reach 10% of private equity assets under management this year. Since 2017, the world’s largest private-equity funds have all launched responsible investing products. With Millennials twice as likely as the rest of the population to buy products from sustainable companies, as they inherit and increasingly create their own wealth, we can expect momentum growth behind this trend.

1 IRR is a discount rate that makes the net present value (NPV) of all cash flows from a particular project equal to zero. IRR is used to estimate the profitability of potential investments.

“The performance of private assets is intrinsically linked to the advantages of active ownership.”
China has been at the epicentre of many long-life news stories that have commanded investors’ attention over the past year. From its trade war with the US to its slowing economic growth and most recently its origin of the coronavirus epidemic, news impacting the world’s second largest economy has investors on edge. It is important to focus on the key fundamentals.

“We expect the Chinese economy to grow by +1.2% YoY in 2020 and +11% in 2021.”

While the coronavirus’s rapid spread did massively hit Chinese growth in Q1 and will still affect Q2 at least, we stay focused on ten factors.

1. Chinese government action
The Chinese government was quick to react to the coronavirus outbreak, implementing radical measures that deliberately sacrificed short-term growth for the sake of containment. In contrast, when SARS broke out in late 2002, it took the government until April 2003 to fully realise the extent of the crisis. This time the alert was raised much more quickly with the publication of more detailed and transparent statistics. The number of new reported cases has declined dramatically and industrial production has resumed on a large scale.

2. Potential impact on the Chinese economy
SARS knocked 2% off of economic growth in 2003, with tourism and related sectors being the hardest hit. Retail sales growth also lost momentum, falling from 9.2% year-on-year (YoY) in Q1 2003 to 6.8% by Q2 2003. Meanwhile, the Chinese property sector, fixed-asset investment and industrial production proved more resilient. We can expect a similar pattern of impact – particularly on tourism. E-commerce sales proved very resilient in Q1 2020, falling only -2% YoY while total retail sales went down by more than -20%. We expect the Chinese economy to grow by +1.2% YoY in 2020 and +11% in 2021.

3. Economic stimulus measures
Global liquidity is being raised further on a massive scale and the Chinese central bank is attentive and active on a daily basis through various channels. Multiple demand-creating fiscal stimuli from various levels of government are also active, helping to buttress growth and offset the contraction caused by the coronavirus outbreak. The contribution of the fiscal package in place represents 2% extra GDP growth so far.

4. The WHO and China’s National Health Commission
While the WHO has declared the coronavirus outbreak a pandemic and cases outside of China surge, China has gradually lifted restrictions. After reporting hundreds or thousands of new coronavirus cases daily throughout much of February, since March China has kept its case load stable at around 80,000. As of writing, nearly all new infections reported by China’s National Health Commission were among people who were recently abroad. As long as these results can be maintained, we can look forward to a continued rise in Chinese economic activity as sectors across the country reboot.

5. The Chinese consumer
Chinese shoppers account for 58% of GDP today versus 35% in 2003. Before the virus hit, retail sales in China were holding solid and given the rise of automation and e-commerce, housebound Chinese residents could conceivably carry on
shopping during the outbreak. Q1 2020 retail sales will be bad but a recovery is already underway.

6. The calendar
Chinese provinces are gradually lifting lockdown rules and we see activity coming back as illustrated by rising power consumption, online travel bookings and the return of pollution. The current risk is of a re-importation of the epidemic from abroad and a collapse in external demand as the rest of the world shuts down.

7. The domestic economy
By imposing strict containment measures, China is automatically serving its domestic economy by keeping spending and capital from fleeing the country. This could add further support to the domestic economy by redirecting funds that would have gone overseas to Chinese businesses.

8. The peak
The SARS outbreak peaked in April/May 2003 and by June the episode was over. This time the peak has already passed in China but is still far from being reached in countries such as the US and India. The risk of epidemic re-importation will persist for longer and prevent a full normalisation of activity. The way China does business with the rest of the world is forced to evolve, with extensive dislocation but not composed of only negative factors. There are some promising thematics evolving in the current context.

9. Real estate
Chinese real estate had performed very well for the past four years up until the outbreak. The sector’s fundamentals remain extremely solid but it is too soon to tell whether the virus outbreak has brought on an early peak. Activity in March appears to be resuming positively, a very important signal. If demand does return, it will bode very well for the Chinese economy in H2 2020. Conversely, if the real estate sector begins a downward trend, it will take a significant toll on the Chinese economy and growth outlook.

10. Overweight China
We maintain our overweight on China, although sector selection is paramount and e-commerce players look particularly well positioned in light of events. Beyond the current coronavirus factor, the ‘phase 1’ US trade deal and the Chinese government’s ability to support the economy while avoiding any crash landing should both be supportive of Chinese growth re-acceleration from the trough in Q1 2020. And while Chinese growth has slowed considerably from impressive levels, an average 6% target over 2020 and 2021 combined would prove, more than ever, one of the highest growth rates globally if achieved.

“Sector selection is paramount and e-commerce players look particularly well positioned in light of events.”

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OUR CHINESE GDP GROWTH ESTIMATES FOR 2020
Base-case scenario year-over-year growth

![GDP Growth Estimates Chart]

Source: Pictet WM – AA&MRI

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PERSPECTIVES ——— APRIL 2020
Corporate governance entails the oversight of how a company is managed and can indicate the quality of how a company is run. Through this it offers insight into the direction and potential risks a company may face in how it conducts business.

Generally speaking, the larger and more complex a company is, the more critical the role of its governance structures. Board structures significantly influence corporate growth and are governed by a legal and regulatory framework to protect shareholder rights. Different geographies determine different board structures. For example, some countries have two-tier boards, with non-executive supervisory boards in place that oversee management boards, while others have single-tier boards.

A few key governance issues for investment analysts include executive pay, audit practices, board independence and expertise, transparency and accountability and shareholder rights. The main reason why a company’s governance is important to investors is in identifying areas of risk, which in the worst case can result in expensive scandals, bankruptcy or both. Everyone is familiar with the Enron and Lehman Brothers bankruptcies, which had devastating consequences not only for shareholders and employees, but also – particularly in Lehman’s case – triggered a global tidal wave of ruin that threatened to take down the financial system and required the rescue by government coffers the world over and set global economic growth back years.

Our investment analysts have been systematically assessing corporate governance as part of their comprehensive analysis process for decades. Corporate governance and the quality of a company’s management can distinguish best-in-class companies from their peers, which is helpful in identifying those with the best potential to deliver superior long-term financial returns.

While our analysts consult environmental, social and governance (ESG) research from external providers, this is but one input to their assessments. Final company recommendations are built holistically, including many other factors built into the due diligence process.

Within the ESG scorecard our analysts develop for the companies they cover, there are several subfactors that make up the governance score component. For one subfactor, audit risk and oversight, in addition to a company’s external auditor’s review, we also consult analysis from Institutional Shareholder Services (ISS), a leading data and analytics provider in the responsible investment space. When reviewing audit risk and oversight, ISS considers actions taken by the external auditor, any recent regulatory action against the company and the composition of its audit committee.

The importance of audit to corporate governance lies in the review by an independent third party of a company’s accounts, in an effort to detect potential fraud and avoid financial scandal. A company’s management is responsible for preparing its financial reports, and it is the auditor’s job to review these in order to identify any irregularities. The robustness of this oversight system gives a picture of a company’s audit risk.
Beyond risk, one key governance criterion that our analysts focus on is a company's return on invested capital (ROIC). ROIC is the amount of financial return a company generates above the average cost it pays for the debt and equity capital it issues. It reveals how efficiently a company spends its capital and manages its costs, and is a useful calculation to compare how companies within an industry are run.

Typically a company is creating shareholder value when its ROIC is greater than its cost of capital (i.e. a weighted average of its total equity and debt). Evidence of an improving ROIC trend can be a good indication of management's discipline and focus on executional excellence. It indicates effective capital allocation and often times a company that is doing well vis-à-vis its peers. It puts emphasis on a company’s long-term success rather than short-term, unsustainable profit.

⋆When management’s incentives are not aligned with ROIC: poor share-price results
One of the companies in our analysts' coverage is a major American food company. After a controlled merger by a private equity group, management was incentivised by profitability. This led to massive short-term cost cutting and an underinvestment in innovation and sales growth, which is critical to a company’s long-term success. The food company’s ROIC ultimately declined as a result and the company suffered significant market-share losses, sending its share price down nearly 60% in 24 months (see chart 1).

✓When management’s incentives are aligned with ROIC: positive shareholder value created
A market-leading home-improvement company sets a contrasting picture. Its management is incentivised to take actions that will promote the company’s long-term growth and success. It targets steady top-line growth in the low-mid-single digit percentage range and combines this with disciplined capital allocation. The company’s capital expenditure is invested in measures to drive future growth. Its strategy is focused on targeting bigger-ticket professional clients and driving omnichannel sales (online as well as in brick and mortar stores), with the aim of being an e-commerce leader in home improvement retail. This, combined with share buybacks, resulted in a steady rise in ROIC and positive shareholder returns (see chart 2).

Why we like ROIC as a metric
When a company’s executive management’s incentive plans are tied to ROIC, it tends to align a company’s strategy with positive long-term shareholder returns. Because our objective is to recommend investments that will protect and grow clients’ wealth over the long term, this is a critical consideration in our company due diligence process.

Corporate governance is like the foundation and structure of a building. The more robust it is, the better the chances that the building will withstand the tests of time and any external shocks like hurricanes and earthquakes that arise along the way. Our analysts aim to identify those companies with strong corporate governance foundations that will stand the test of time as investments.
In a market freefall, you cannot escape gravity. In the absence of liquidity, all assets become subject to selling pressures, including those that are both passively and actively managed. However, by avoiding a blanket approach to exposure selection and applying an appropriate degree of due diligence, investors can be strategic in the use of both active and passive instruments in their portfolios.

Index investing, commonly through the use of exchange traded funds (ETFs), is one of the most broadly applied approaches in the passive investing space. Indeed, ETFs are excellent instruments that have a place within portfolios, particularly in the more-liquid asset classes such as core or large-cap equities; liquidity has not yet been an issue for these in the current bout of market stress.

However, ETFs in the less-liquid parts of the equities market, including small/midcaps and peripheral markets, have faced challenging liquidity constraints due to the nature of their underlying instruments. For example, a Philippines market tracking ETF was recently trading at as low as an 18% discount to its NAV (net asset value), meaning investors were willing to sell at prices worth one-fifth less than the underlying assets themselves.

Elsewhere, investing in fixed-income ETFs can be problematic. While in equities, there is a greater focus on distinguishing the winners from the losers, in fixed income, the objective is to avoid the losers – those issuers that will eventually default. Because default rates have been so low over the last decade of easy monetary policy, this rule of thumb can be more easily overlooked. High-yield debt has a default rate of 5-6%, on average. That means in an ETF basket exposed to this entire market segment, investors accept a 5% default rate in their investment. However, in fixed income, unlike in equities, gains are capped by the coupon (interest payment) and investments can go to zero in a default. So when default rates start rising, this can present real challenges and significant losses. It is especially critical to avoid those “torpedoes” (companies that will default) in the credit space – and to focus on distinguishing the winners from the losers in stock picking. This is where an active approach to selection is advantageous.

“The key is to be well-acquainted with your managers’ style, consistency and investment processes through robust and long-term due diligence.”

The other issue with fixed income-index replication is that it gives investors greater exposure to the most indebted issuers, which compose a bigger share of the index. Credit events like downgrades will hit the most indebted players hardest, so in times of market stress, it is all the more critical to avoid these issuers, which an active approach allows for.

The importance of due diligence
When correlations rise and fire sales are taking place across markets, whether your exposure is active or passive, your assets will fall with the rest on the way down. However, on the way up once markets start to recover, those investment instruments that are highest quality and most resilient, meaning with strong, well-disciplined balance sheets and low debt levels, will distinguish themselves from the rest. This is when active management can pay off. The key is to be well-acquainted with your managers’ style, consistency and investment processes through robust and long-term due diligence. This way when the recovery does arrive, you know exactly what your active manager is doing and can benefit from the selection process.

You cannot escape gravity – when everything is falling, there is no place to hide. The key rather is in doing your homework beforehand so that you know which investment instruments and active managers will be best positioned to benefit on the way up, having picked higher quality assets that will perform better in a recovery.

Active versus passive investing in times of market dislocation

Stressed markets have gone through a period of extended market dislocation in recent weeks – when liquidity dries up and assets are no longer priced correctly on an absolute or relative basis. We look at the advantages and disadvantages of active and passive exposure under these conditions.
Large endowment funds have outperformed both pure equity allocations and classic 60/40 portfolios over the long term. Our analysis also shows that large endowment funds should come through the latest market dislocation comparatively better than pure equity allocations.

Endowments are non-profit organisations funded through gifts and donations. Many institutions, particularly in the US, have endowments, including universities, museums and hospitals. The largest endowment funds are held by American universities, led by Harvard University (USD 39.4bn in assets under management (AUM) at end-June 2019), followed by the University of Texas and Yale University (with USD 31bn and USD 30.3bn, respectively).

The primary investment objective of university endowments is to generate sufficient returns to maintain the purchasing power of their assets in perpetuity for future generations and to sustain the university’s operating budget. In general, endowments target a real average annual return of 5-6% (adjusted for inflation) over the long term.

Over time, the larger endowment funds have significantly reduced their exposure to traditional asset classes such as public equities and bonds (see chart), moving instead to alternative assets such as private equity, real assets and absolute-return strategies, which provide the benefits of diversification and a higher risk premium. By nature, alternative assets offer opportunities to exploit inefficient market pricing through active management. Larger endowment portfolios’ weighting of alternative assets is far greater than smaller ones’ because investing in illiquid assets tends to considerably smooth market volatility. In the end, higher risk leads to higher returns, but large endowments produce better risk-adjusted returns than classic portfolios, with illiquid assets key to their performance.

“Large endowments produce better risk-adjusted returns than classic portfolios, with illiquid assets key to their performance.”

Large US endowment funds’ allocation to public equities decreased from 45% in 2002 to 31% in 2019 (having fallen to as low as 26% in 2009), while their allocation to alternative assets increased from 32% to approximately 57% over the same period. At the end of June 2019, the Yale endowment fund, the third largest in the US, aimed to have around 3/4 of assets allocated to alternative assets.

From June 1996 to June 2019, large endowment funds (over USD 1bn in AUM) posted an average annual return of 9.1% compared with 8.7% for the S&P 500 and 7.7% for a balanced US portfolio consisting of 60% S&P 500 and 40% US Treasuries (usually labelled a 60/40 allocation). Despite the outperformance relative to equities (+40 bps) our analysis shows that endowments’ volatility was closer to that of a balanced portfolio (10.9% vs 16.1% for the S&P 500 and 9.1% for the US 60/40). In other words, endowment allocation in the long run made it possible to combine equity-like returns with the risk of a balanced portfolio. This should come as no surprise as investing in illiquid assets tends to considerably smooth market volatility. In the end, higher risk leads to higher returns, but large endowments produce better risk-adjusted returns than classic portfolios, with illiquid assets key to their performance.

To understand how endowment funds fare during crises, we can look at the bursting of the TMT bubble in 1999-2000 and the global financial crisis in 2008-2009. In 2000, large endowment
funds outperformed both pure equity and US 60/40 portfolios, according to our analysis, whereas in the financial crisis they outperformed equity portfolios, but not balanced ones. This highlights that the endowment style of investing is more geared towards maximising risk-adjusted returns over the long term than smoothing returns and offering the protection of long-term sovereign bonds.

From 19 February to 23 March 2020, the S&P 500 fell by -33.8% (in USD) and the US 60/40 by -18.8%. Using long-term strategic asset allocation and listed proxies for all the various assets, the potential theoretical loss for endowment funds in the same period should be in the range of -20-25%—better than the S&P 500 but worse than US 60/40, as the decline in yields offered a buffer against the equity drawdown. In a word, the endowment investment style can help cushion significantly against declines in equity markets, but investors should make sure they do not need to sell illiquid assets urgently, as this will sap the endowment approach of its very essence.

Another way to estimate how endowment funds fared during this period is to use the monthly performance of University of Texas System (UT System), the second-largest fund in the same period should be in the range of -20-25%—better than the S&P 500 but worse than US 60/40, as the decline in yields offered a buffer against the equity drawdown. In a word, the endowment investment style can help cushion significantly against declines in equity markets, but investors should make sure they do not need to sell illiquid assets urgently, as this will sap the endowment approach of its very essence.

“Investors should make sure they do not need to sell illiquid assets urgently, as this will sap the endowment approach of its very essence.”

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