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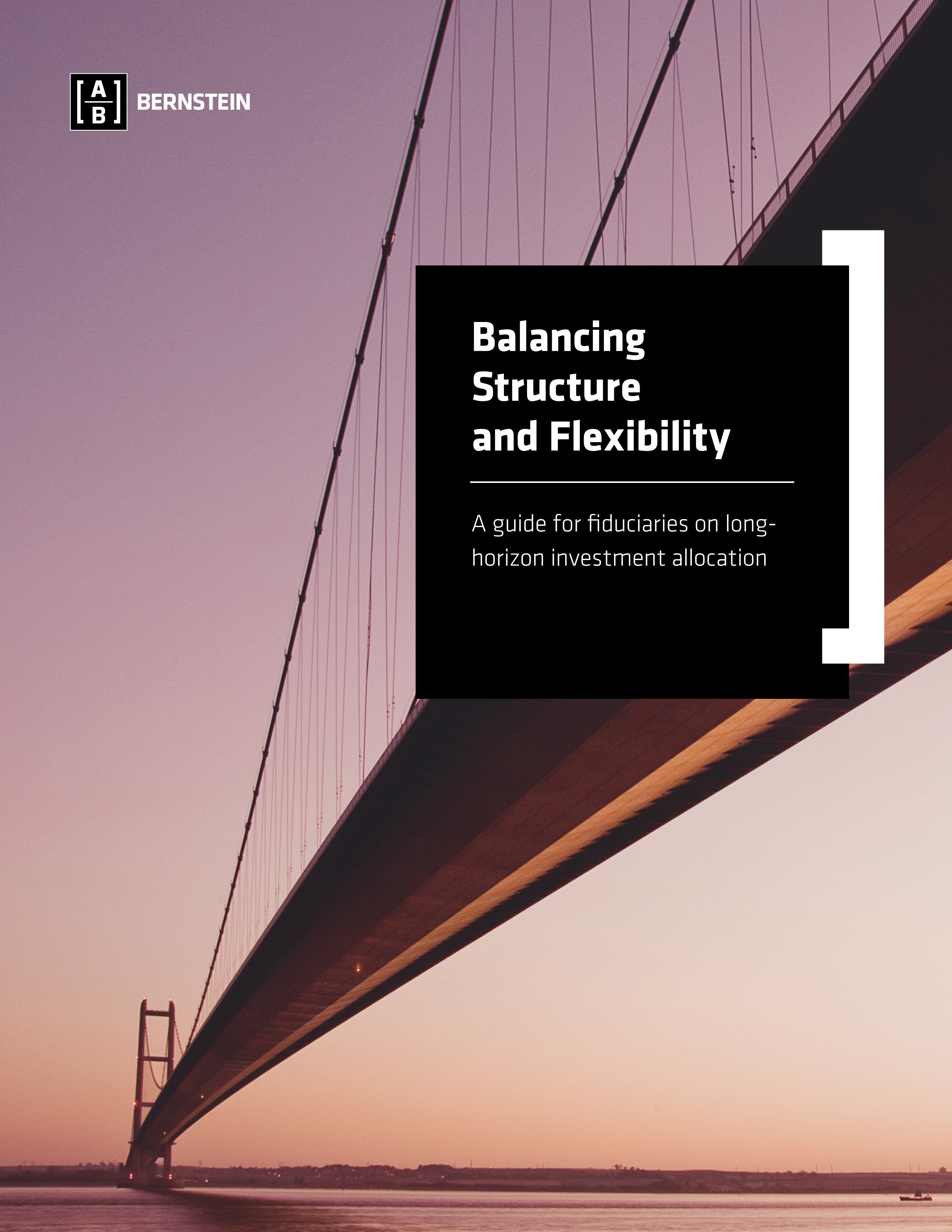
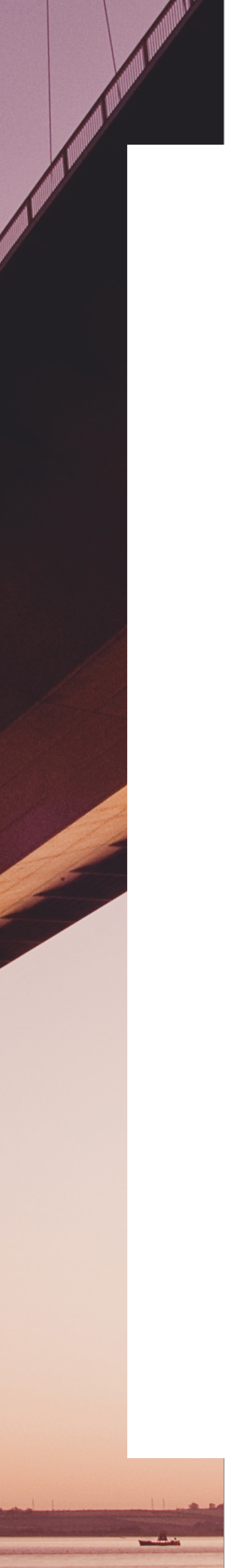


Balancing Structure and Flexibility

A guide for fiduciaries on long-horizon investment allocation



A Steep Hill to Climb

As a fiduciary, your mission is clear: sustain distributions while growing portfolio assets without assuming undue risk. Yet, that's easier said than done. And given the market landscape, investment committees will likely face an uphill battle in the years to come.

Investors have grown accustomed to strong returns in the wake of the global financial crisis. In fact, global equity markets returned over 12% from 2009 through 2021—twice the pace seen in the decade leading up to the crisis.[1] Plus, inflation remained dormant, while falling interest rates kept bond returns solidly in positive territory.

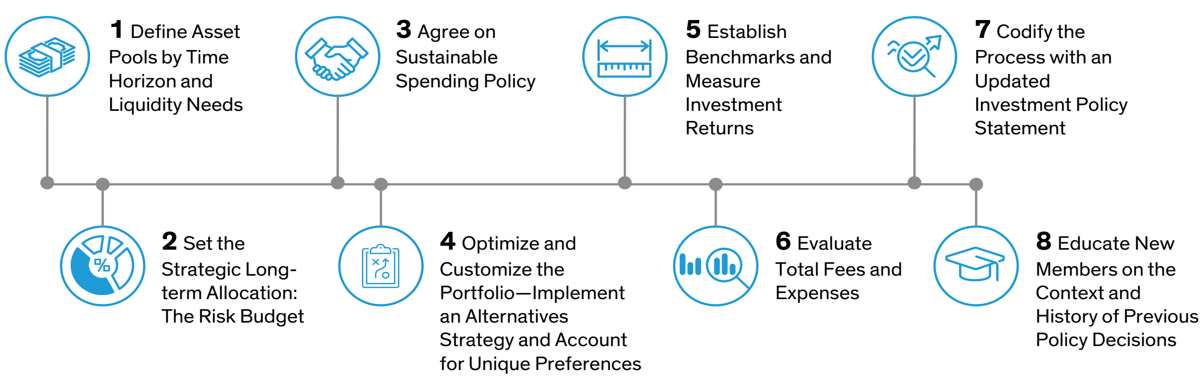
But the pandemic and its ripple effects have rocked the boat. Supply chain disruptions, lockdown policies, and government stimulus aimed at preventing a disruptive recession sent inflation soaring to levels not seen in decades. In response, central banks raised interest rates swiftly and substantially, causing both equity and bond markets to decline in 2022.

Since then, inflation has gradually receded, helping markets recover and even reach new heights. Does that mean the economy will head back to the era of ultra-low inflation and near-zero interest rates? We don't think so. As we survey the landscape, we project lower returns for diversified portfolios than we have experienced in the last several years. Consider that a simple 70% equity/30% bond portfolio that delivered 7.3% in the last decade (including the rocky 2022 period) may only generate 5.9% in the next.[2] What's more, price hikes have accumulated, pressuring institutions' budgets. And ongoing (though lower) inflation adds to the strain. Taken together, this means tax-exempt investors will likely find it difficult to sustain distributions and maintain—let alone grow—their portfolios.

Now, more than ever, fiduciaries need a strategic plan. One that's flexible enough to adapt to the current and prospective market environments while designing a structure to achieve long-run objectives.

We lay out a path to building that solid fiduciary foundation herein (*Display 1*). It starts with defining asset pools by purpose and time horizon before eyeing a strategic allocation for your long-term endowment. With the risk budget in place, organizations can move to spending policy. Considering ways to optimize the portfolio—such as with alternative investments—can help to achieve your desired goals. Defining measures of success while accounting for fees and expenses will allow organizations to monitor how they're tracking relative to plan. Finally, codifying the process with an investment policy statement will help current decision-makers navigate challenging environments, educate new board members, and provide institutional memory for future leadership.

DISPLAY 1: THE PATH TO BUILDING A SOLID FIDUCIARY FOUNDATION



Source: AB

1 MSCI World Index—return from Jan 2009 through Dec 2021 was 12.33%; from July 1998 through June 2007, 5.99%.
2 Historical 10-year return for a 70% MSCI World and 30% US Aggregate Bond Index portfolio through July 2024. Projections based on AB's estimates of the range of returns for those indices.

Matching Strategy to Purpose

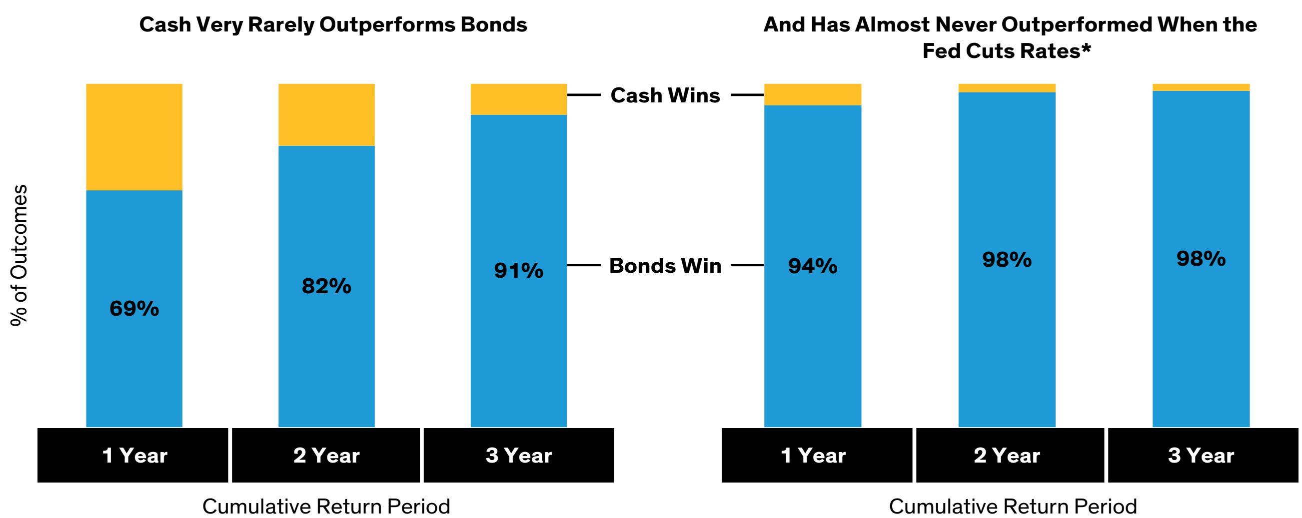
Many organizations have increased their cash holdings in recent years with events like stimulus funding or receipt of unrestricted philanthropic funds. With short-term interest rates skyrocketing to over 5%, it's tempting to let funds accumulate in stable and liquid money market funds. But, as attractive as current returns may seem, cash very rarely outperforms over longer periods. That's why it's vital to move excess funds to your long-term portfolio (*Display 2*).

So how much cash should an organization hold? Cash provides a vital financial cushion while helping meet short-term spending needs. However, other conservative investments can also play a role in planning for spending over an intermediate-term horizon of two to three years.

When sizing cash positions, we think about matching the investment strategy to the purpose of the funds. That's why Bernstein has developed a proprietary tool designed to right-size asset pools earmarked for different time horizons. Instead of relying on rough rules of thumb, our tool considers factors specific to each organization—such as risks around revenue, flexibility of spending, timing differences in cash flows, and ability to borrow. The analysis helps fiduciaries decide how much risk is prudent for their organization across a variety of asset pools with distinct purposes and needs.

Once an organization knows the size of their short- and intermediate-term portfolios, we can establish optimal allocations that match the relevant time horizons. Assets marked for imminent spending should remain in cash, but assets that won't be spent for one to three years can take on marginally more risk, in exchange for a slightly higher return.

DISPLAY 2: CASH RARELY WINS



As of March 31, 2024. **Past performance does not guarantee future results.**
*Rate cut outcomes are defined as the beginning of return period federal funds' effective rate through the end of return period federal funds' effective rate. Bonds represented by the Bloomberg US Aggregate Index. Cash represented by the Bank of America 3-Month Treasury Bill Index.

Driving Long-Term Performance

With short- and immediate-term spending accounted for, we can begin setting the long-term portfolio's strategic asset allocation, which serves several important functions:

- Establishes the total return necessary to satisfy withdrawals or distributions (investment objective)
- Determines the fund's expected life (time horizon)
- Gauges the ability to weather sustained drawdowns (risk tolerance)

Choosing a mix of stocks, bonds, and diversifying investments based on these factors is one of the most important investment decisions an organization will make.

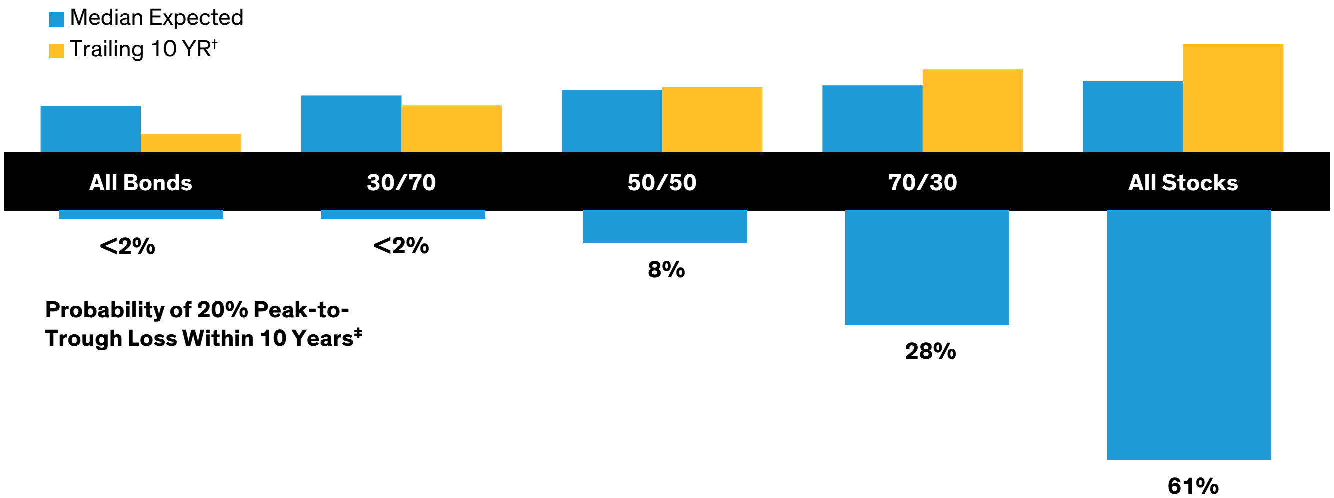
For instance, consider a classic risk-return trade-off—the allocation between stocks and bonds. Over the long term, stocks tend to be a growth engine while offering a better hedge against rising inflation. But they can be quite volatile over shorter periods. High-quality intermediate bonds, which tend to have a low correlation to stocks, typically help offset equity volatility. That's because investment grade bond returns have historically been far more predictable, though they offer a lower expected return than stocks.

When the share of equities in a diversified portfolio increases, say from 50% to 70%, the projected 10-year annualized return climbs from 5.5% to 5.9%. While this may not sound like much, that extra return would add more than $1 million to a $20 million portfolio over a 10-year period with reinvestment. At the same time, making that adjustment also heightens the probability of a 20% peak-to-trough drawdown from 8% to 28% (*Display 3*).

It is likely that taking on more equity risk won't yield the same returns as it did in the past decade. In fact, allocations heavily weighted toward stocks are projected to fall significantly short of recent returns (*Display 3*). This poses an even greater challenge when it comes to making decisions around long-term strategic allocation.

DISPLAY 3: THE RISK-RETURN TRADE-OFF

Annual Distribution Spending (Left Axis) and Endowment Portfolio Value (Right Axis)
USD '000s, nominal, 70% stock/30% bonds (USD thousands)



Initial assets of $20 million, with a three-year smoothing spending policy.

Asset allocation is 70% Global Stocks/30% Intermediate Taxable Fixed Income. See Notes on the Bernstein Wealth Forecasting System in the Appendix of this presentation.

Set the Course and Adapt

Along with expected returns, organizations should also consider the effects of inflation when thinking about how much they can sustainably distribute. For example, organizations with a traditional 70% stock/30% bond allocation may be surprised to learn that the amount they can spend and also maintain the inflation-adjusted portfolio value is 3.6%—a figure that's likely lower than they'd hoped.

To adjust their inflation-adjusted return expectations, organizations have three choices:

- source additional revenue
- change withdrawal patterns
- shift their asset allocation

Since assessing revenue opportunities lies outside the scope of this paper, we will focus on distribution policies and asset allocation.

Spending Now and Later

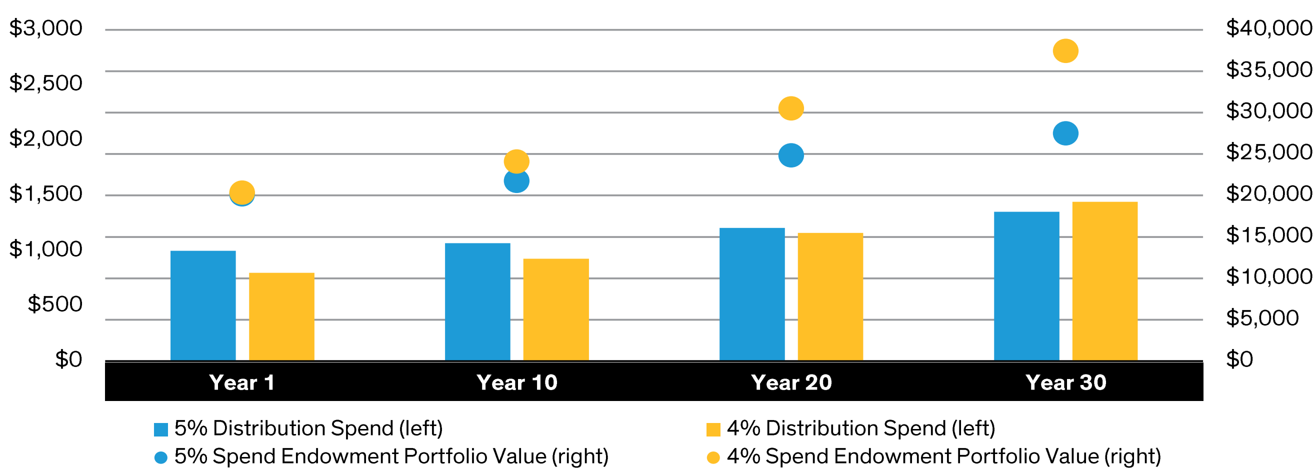
Many organizations wonder how much they can sustainably spend. In other words, what is a realistic distribution rate that will still maintain the portfolio's principal value?

To answer this, you must first put the trade-offs between current and long-run spending into perspective. Withdrawing more today generally lowers the likelihood of maintaining distributions over time. That's because the combination of inflation and higher spending will cut into the principal value each year. At a 5% withdrawal rate, a tax-exempt investor would only have a 23% chance of maintaining purchasing power of the portfolio over the next 30 years. Yet if you decrease withdrawals, say by 1% (from 5% to 4%), the likelihood of maintaining purchasing power over 30 years would more than double.

Put simply, withdrawing less today means more is available for the future (*Display 4*). The 4% withdrawal rate represents lower annual distributions initially, but gradually the gap between this rate and 5% annual distributions closes. The difference in distributions narrows over time. Once the crossover point is reached, the 4% policy will distribute more annually and still leave the endowment with higher remaining assets.[3]

DISPLAY 4: WITHDRAWING LESS TODAY MEANS MORE AVAILABLE FOR THE FUTURE

Annual Distributions Spending
USD millions, nominal, 60% stock/40% bonds (USD thousands)



Initial assets of $20 million, with a three-year smoothing spending policy. Asset allocation is 60% Global Stocks/40% Intermediate Taxable Fixed Income. Global Stocks are 12.0% US Diversified, 16.2% US Value, 16.2% US Growth, 6.0% Small-/Mid-Cap, 9.6% US Low Vol Equity, 21.2% Developed International, 8.1% Emerging Markets, and 10.7% High-Risk International. Fixed Income is 100% US Intermediate-Term Taxables. See Notes on the Bernstein Wealth Forecasting System.

3 Assumes initial assets of $20 million and 3-year smoothing. Maintaining purchasing power is the probability that the endowment portfolio can maintain or exceed their initial assets of $20 million after 30 years in real dollars. Assumes an asset allocation of 70% Global Stocks/30% Intermediate Taxable Fixed Income.

Over the long run, the impact can be dramatic. To measure the potential impacts of different spending policies over time, we use a metric called Total Philanthropic Value (TPV), which is the sum of cumulative distributions in a given period, plus the ending remainder value. Using this metric, our research has shown just how meaningful spending choices can be, especially for foundations with a long-term view.

But for some private foundations and other institutions, reducing distributions may not be an option. Instead, many would like to spend more. For these organizations, fiduciaries need to consider ways to enhance returns to meet distribution needs if they aim to last into perpetuity.

Going Beyond Stocks and Bonds

Historically, increasing the allocation to equities was a common way to boost returns. However, as we mentioned earlier, this approach comes with its own set of drawbacks, including increased volatility and a higher risk of experiencing significant losses. And, in the current market environment, the advantage of adding more equity is expected to be limited. To address this challenge, alternative investments can be used to help organizations achieve their return goals. These investments offer sources of risk and return that differ from the traditional stock/bond mix and can help fill in the gaps. Examples of such strategies include private equity, private credit, and hedge funds, as well as securities related to "real" or nonfinancial assets, like real estate.

While investing in alternatives generally means accepting illiquidity, additional complexity, and higher fees, the risk and return benefits can be substantial. Pure alternative investments provide diversification: the pattern of returns tends to differ from that of public equities and bonds, dampening portfolio volatility. What's more, investors are usually compensated for holding these less-liquid assets: the illiquidity premium, or excess return, varies greatly, but often adds several percentage points annually.

Exposure to alternatives also offers access to a broader opportunity set. The number of publicly traded stocks is shrinking (a trend that started in the last few years), while the number of private companies has risen. Investors who confine themselves to publicly traded securities will miss out on a larger part of the investment universe—and one that has historically produced robust returns. For example, private equity returns over the past 20 years exceeded those of stocks by roughly 400 basis points or 4%, compounding at 13.6% net of fees.[4]

Larger endowments have capitalized on this opportunity, making alternative investments a cornerstone of their strategic allocations. In fact, a recent study found that private foundations with assets over $500 million allocated an average of 41% to illiquid alternatives—including private equity, venture capital, and real assets like private real estate—while those below $101 million allocated considerably less at 14% (for community foundations, those figures were 19% and 7%, respectively).[5]

4 As of September 30, 2023. Past performance does not guarantee future results. US Stocks are represented by the S&P 500 Index. Private Equity is represented by the Preqin Private Equity Quarterly Index. Source: Preqin, S&P, and AB.
5 Council on Foundation/Commonfund Study of Foundations 2022.

Why the gap? Larger organizations have historically tapped more desirable managers and a greater array of investment products. But today, many more options are accessible to "qualified purchaser" institutions with portfolios of $25 million or more, as well as "accredited investor" institutions with $5 million and up. The difference can also be explained by the fear of a liquidity squeeze—or inability to access sufficient funds when needed—as well as the increased due diligence required to invest in these more complex, illiquid investments (*Display 5*). But meeting withdrawals should not be an impediment to adding illiquid investments. Most annual withdrawal rates are 3%–5%, and even if 15% was allocated to illiquid strategies, the remaining 85% of the portfolio is still available to meet liquidity needs.

An Alternative Plan

To optimize their long-term portfolios, organizations should think about diversifying not only *with* alternatives, but also *within* alternatives. Whether an organization is just starting to build out an alternative allocation—or if they've already invested over the years—a well-considered plan for overall exposure can be a valuable tool.

Bernstein provides strategic and comprehensive advice for capital allocation that goes beyond providers and products. At the heart of our advice is Bernstein's proprietary capital market engine—a distinctive, proven model that projects 10,000 plausible evolutions of the capital markets from today's market conditions, ranging from spectacular to dismal. And unlike those offered by peers, Bernstein's analytics are global and multicurrency, factoring in the prevailing economic environment along with cross-asset class correlations. Above all, our model treats asset allocation as a journey, rather than a singular destination. It sets long-term, aspirational targets, which allows for fine-tuning along the way. And it is flexible, dynamic, and adaptable, responding to changing circumstances and opportunities that arise.

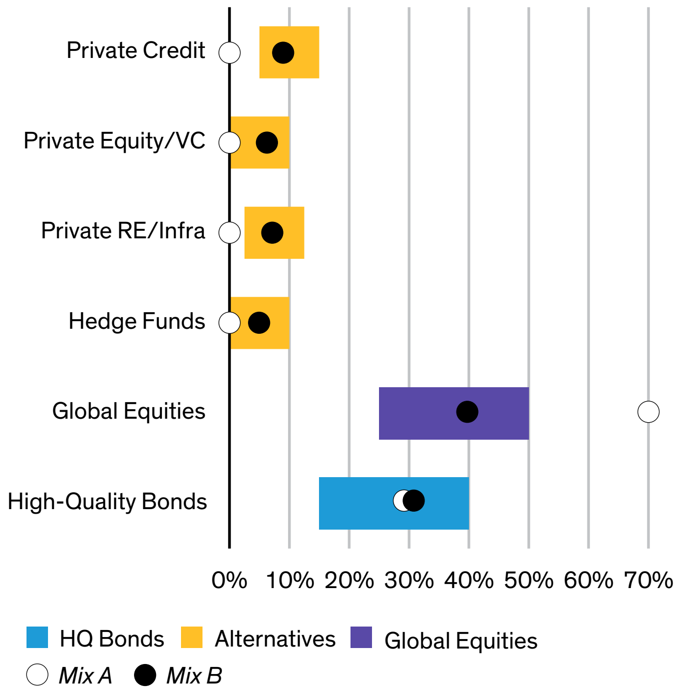
DISPLAY 5: CONSIDERATIONS FOR INVESTMENT COMMITTEES ADDING ALTERNATIVE INVESTMENTS

Liquidity Shortfall Risk	Allocation Drift Risk	Reporting, Valuation, and Taxation	Fee Structure
• Liquidity Shortfall Risk (LSR) refers to the likelihood of running out of accessible money at some point over the next 10 years. • If an investor spends from a portfolio, we avoid allocations that have even a small probability of running out of cash.	• This risk is the degree to which asset weights drift over time due to disparate patterns of return. • Recalibrating drift is difficult, because illiquid investments, when their weights rise, cannot be sold to rebalance into liquid investments.	• Alternatives often have delays in performance reporting of a quarter or more to account for time to value non-publicly traded assets. • Certain investments require filing K-1s. • Some investments may produce UBTI. While not prohibitive, ensure the return is worthwhile given potential complications. Consult with your tax advisor.	• Alternative investments have different and more complex fee structures. • The fees may include management fees as a percent of committed or invested assets, along with fees based on performance, or a percentage of the return, often above a preferred rate.

Source: Bernstein

Consider *Display 6*, which shows the output of our model—sample target ranges for exposures to various alternative asset classes. Mix A represents a traditional 70% stock/30% bond allocation, while Mix B shows an allocation incorporating 30% alternative investments. To arrive at these ranges, our model considers an organization's risk appetite, spending needs, and tolerance for illiquidity. As a bonus, this analysis provides a quantitative rationale for incorporating a more specific asset allocation target in an investment policy statement.

DISPLAY 6: MODEL-DRIVEN ASSET ALLOCATION RANGES PROVIDE A ROAD MAP



The results of adopting a well-diversified alternatives allocation are meaningful both in terms of portfolio volatility, and the desired "destination" meeting long-term investment goals. For example, building out a 30% allocation to alternatives—sourced from equities—can enhance the expected return from 5.9% to 6.8% while delivering a smaller expected peak-to-trough loss (*Display 7, see next page*). For organizations hoping to generate a return exceeding their distribution plus inflation, adding alternatives can mean the difference between success and failure.

Choosing the Path

With a destination in mind, the next step is to choose the path to get there by selecting specific strategies. There is usually more than one route, and organizations can tailor their allocations to fit their specific preferences.

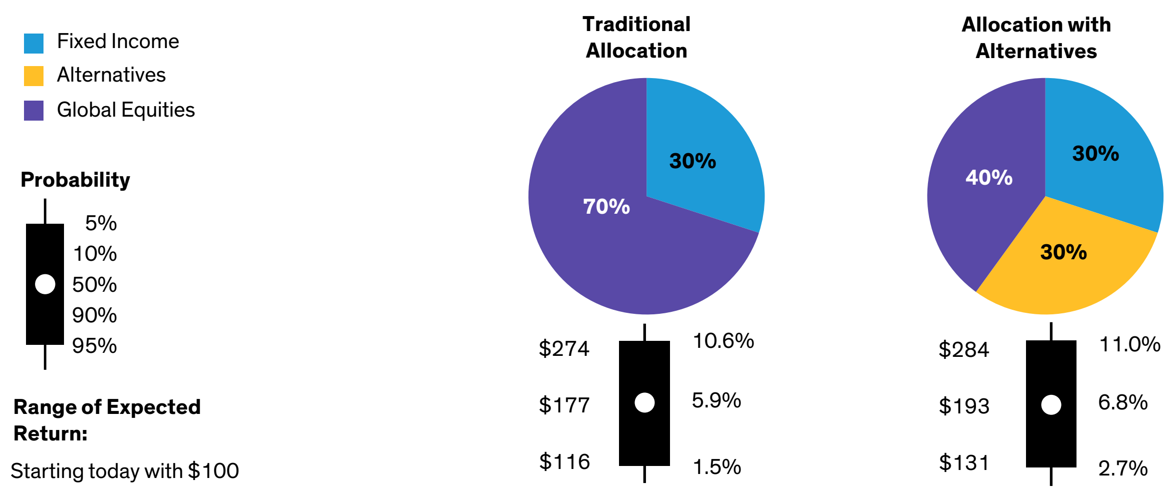
For instance, when it comes to traditional stock and bond allocations, many fiduciaries vacillate between "active" or intentional security selection and "passive" or index-tracking strategies. Yet we don't see it as an either/or decision. Within equities, one approach is to choose active strategies in the areas of the market where managers have the best chance to outperform—namely, smaller-cap companies and less-liquid foreign markets. Lower-cost passive strategies can be focused in the most efficient markets where it is more difficult to gain a competitive edge. This allows organizations to focus their fee budget on strategies that are best positioned to deliver idiosyncratic returns.

Some organizations may also want to consider aligning their portfolios with their mission by choosing responsible investing strategies. Of course, responsible investing means different things to different institutions, and being mission-aligned depends on what your mission is. Some institutions, for example, are adopting formal policies addressing diversity, equity, and inclusion when it comes to their investment managers—going beyond how the portfolio is invested to who is overseeing it.[6] It's also important to note that purpose-focused investing is not a binary choice, but rather a spectrum. Responsible investing strategies range from negative

6 NACUBO-Commonfund Study of Endowments 2023.

DISPLAY 7: ADDING ALTERNATIVES CAN IMPROVE INVESTMENT OUTCOMES

Adaptable to Your Circumstances—*Over a Strategic 10-Year Horizon*



Volatility:	13%	8%
Peak to Trough (90th–Med–10th):	(26%) - (13%) - (5%)	(21%) - (8%) - (2%)
Prob. Of 20% Loss:	22%	11%
Tail Risk:	(21%)	(20%)
Average Income:	3%	3.3%
Weighted Average Lock-up:	~5 Days	~2 Months

Simulated or hypothetical performance results have certain inherent limitations. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve returns or a volatility profile similar to those being shown.

screening to thematic approaches to impact investing. Organizations don't need to own every segment of the responsible investment universe and should consider a variety of styles to diversify exposure. Investors should also recognize that while it isn't necessary to give up returns to invest responsibly, the path of returns will be different than that for traditional strategies. Importantly, our research suggests that fiduciaries need not shy away from responsible investing to fulfill their duties.

Regardless of the chosen path, the choice of managers for each investment strategy matters—especially for less-efficient asset classes like alternatives. With no shortage of options, decisions should only be made after rigorous due diligence, with an eye toward future (not past) returns. Organizations should carefully inquire into the investment manager's selection process—not only for initial investments into specific strategies, but also for evaluating and potentially replacing them over time.

Measuring Success

While the way organizations grade success differs, measuring progress in supporting the overall mission is paramount across the board. A review of investment fund performance—while weighing the stated objectives, guidelines, and policies—should focus on ensuring the investments are supporting the organization's mission in a way that is consistent with its risk budget and values.

Performance should be assessed at least annually, though more frequent reviews are advised. The overall portfolio should be compared to a portfolio with similar risk and return attributes—a risk-weighted benchmark that represents the global opportunity set of all publicly traded equities and fixed income (e.g., 70% MSCI ACWI IMI and 30% Bloomberg Aggregate Bond Index). Though the benchmark will not match precisely, this comparison is designed to assess the impact of the strategic allocation, tactical moves, and security selection decisions made by the investment manager(s).

Each underlying strategy should also be individually evaluated against the appropriate benchmark to surface any anomalous results. Importantly, investment results should not just be disclosed by an investment manager; they should be explained clearly so fiduciaries understand the source of returns and feel confident that they are meeting their oversight responsibilities. Performance should always be viewed net-of-fees—and that means *all fees*.

Uncovering Fees

Investment fees and expenses are a frequent source of confusion due to lack of uniformity among investment managers. Often there are layers of fees, though they generally fall into two broad categories. The first are fees for investing the assets, commonly referred to as management fees or underlying investment costs. The second category are fees for advice and servicing of the portfolio, including administrative and custodial services and other expenses that may or may not be readily disclosed. Committees should regularly review these expenses with their investment manager to confirm that they are appropriate.

Creating Institutional Memory

At this point, the number of decisions adds up. That's why documenting the choices and codifying them with an investment policy statement (IPS) is an important step in establishing an investment program, and a key task for fiduciaries. Even the most well-designed plans face challenges, particularly during periods of heightened volatility and uncertainty in the markets. An IPS provides direction and reassurance for sound decision-making in times of stress, answering questions like:

- who is responsible for identifying potential portfolio shifts;
- what is the process for implementing these changes; and
- how is risk measured and managed around these moves.

The IPS should be flexible enough to grant an investment manager the freedom to move around target allocations with certain preapproved bands without seeking approval. These shifts should be geared toward managing short-term portfolio risks and mitigating extreme outcomes.

The IPS should be considered a living document. If left untouched, it can quickly become stale and outdated. We recommend reviewing and ratifying the IPS annually even if changes are only made every 3–5 years, or when there is a change in an organization's needs and objectives.

The Big Picture

Every short-term investment environment comes with its own set of trials, making it easy to lose sight of the importance of a long-term strategic asset allocation. To sustain your organization and meet its distribution goals over the long haul, it's crucial to follow a process that plans and implements a proper strategic allocation, considering a mix of asset classes and management approaches. This may mean moving beyond traditional stock and bond portfolios to diversifying, illiquid assets that enhance returns without assuming greater risk. It also means measuring outcomes, with an eye toward ultimately achieving your mission.

"Even the most well-designed plans face challenges, especially in periods of heightened volatility."

Notes on the Bernstein Wealth Forecasting System℠

The Bernstein Wealth Forecasting System℠ uses a Monte Carlo model that simulates 10,000 plausible paths of return for each asset class and inflation and produces a probability distribution of outcomes. The model does not draw randomly from a set of historical returns to produce estimates for the future. Instead, the forecasts: (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of the analysis; and (4) factor in a reasonable degree of randomness and unpredictability. Moreover, actual future results may not meet Bernstein's estimates of the range of market returns, as these results are subject to a variety of economic, market and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

Alternative investments involve a high degree of risk and are designed for investors who understand and are willing to accept these risks. **There can be no assurance that any alternative investment strategy will achieve its investment objectives.**

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