Brown Brothers Harriman

InvestorView

INSIGHTS AT THE INTERSECTION OF WEALTH, FAMILY, AND VALUES

The U.S. Economy at Midyear 2024

Summer 2024

InvestorView

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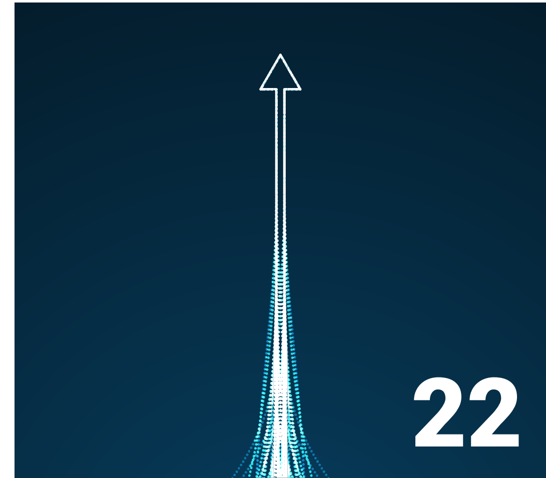

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Dear clients and friends,

Happy summer! We hope that you had a successful first half of the year and are enjoying these warmer months.

In the feature article of this issue of *InvestorView*, BBH Partner and Chief Investment Strategist Scott Clemons looks at the state of the U.S. economy as we head into the second half of 2024. He examines several cracks in the façade of consumer spending that may imply a looming deceleration in economic growth.

In another article, Chief Investment Officer (CIO) Justin Reed, Deputy CIO Ilene Spitzer, and Head of Client Portfolio Management and Strategy Niamh Bonus discuss our Investment Research Group's approach to portfolio construction. They break down our unique three-step process and examine how we use these allocation frameworks to construct custom portfolios that meet each client's risk/return objectives, as well as goals and liquidity needs.

We also hear from BBH Partner and CIO Emeritus Suzanne Brenner and Deputy CIO Ilene Spitzer about asset allocation for endowments and foundations (E&Fs). They discuss the special considerations that are key to successful asset allocation for E&Fs and dive into the role private investments can play in such a portfolio.

Finally, Fixed Income Product Specialist Tom Brennan covers the pillars of our fixed income investment philosophy that we believe position us to weather a variety of market environments.

We hope you enjoy this issue. If you have any questions about the topics covered, please do not hesitate to reach out.

Best,

G. Scott Clemons, CFA
Partner

Justin Reed
Partner

CRACKS IN THE FAÇADE

The U.S. Economy at Midyear 2024

By G. Scott Clemons, CFA
Partner
Chief Investment Strategist

Americans like to spend money. A lot of it. Last year, we and our 333 million fellow citizens consumed $19.2 trillion of goods and services, equal to 68 cents of every dollar of gross domestic product (GDP).

Although the tailwind of pandemic-era stimulus largely came to an end in 2021, excess savings, a strong job market, and buoyant housing prices continue to bolster both the ability and willingness of people to spend money, to the benefit of economic growth. As goes the consumer, so goes the economy, and the consumer is going strong.

The resilience of consumer spending is impressive. Most analysts expected that 2023 would mark the long-awaited economic hangover from the trillions of dollars of fiscal stimulus that took place in the wake of the pandemic-induced recession. We're still waiting.

Real GDP (economic activity adjusted for inflation) actually rose 2.5% in 2023, an acceleration on 2022's growth pace of 1.9%. The economy added over 3 million jobs in 2023, followed by 1.2 million more in the first five months of this year. The unemployment rate has been at or below 4% for 30 consecutive months.

Despite the rapid rise in mortgage rates, average housing prices nationwide are up 7.2% year over year, which, although a stiff obstacle to first-time home ownership, is a boon to the strength of household balance sheets.

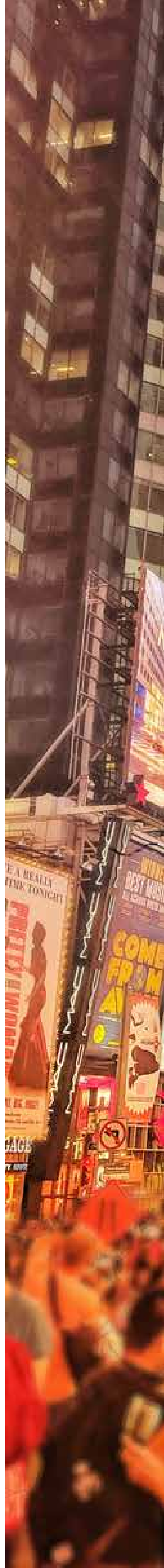
This is about as good as it gets.

And therein lies the problem. Economic conditions in the United States at present remind us of the old witticism that "the optimist believes that we live in the best of all possible worlds, and the pessimist fears this is true."

As we cross the midyear mark and head into the second half of 2024, we see several cracks in the façade of consumer spending that imply a looming deceleration in economic growth, including diminished strength in the labor market, a rise in consumer debt, a drop in household savings, and a worrisome increase in debt delinquencies.

The Labor Market

The simple model of supply and demand helps to explain the robust job market over the past few years. The labor market had been tightening for a decade prior to the pandemic, as job openings steadily rose (the blue line in the nearby graph) while the available supply of labor (the red line) dropped.



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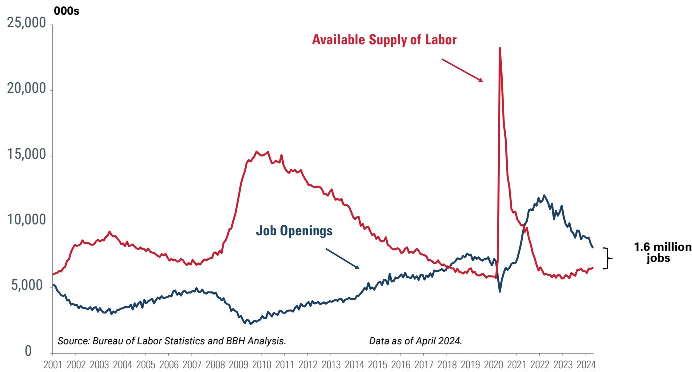


Coming out of the pandemic, companies were desperate for workers, and a sharp rise in job openings reflected this desperation. In March 2022, the imbalance between the supply of and demand for workers topped 6 million, creating a tight labor market and upward pressure on wages.

On an anecdotal basis, this was a constant refrain from our own clients at Brown Brothers Harriman (BBH) just a few years ago: Regardless of geographic location, size of business, or type of industry, workers were hard to hire, and companies therefore wanted all they could get. Job growth subsequently soared. All of the jobs lost during the pandemic had been restored by June 2022, and since then the economy has added a further 6.1 million jobs.

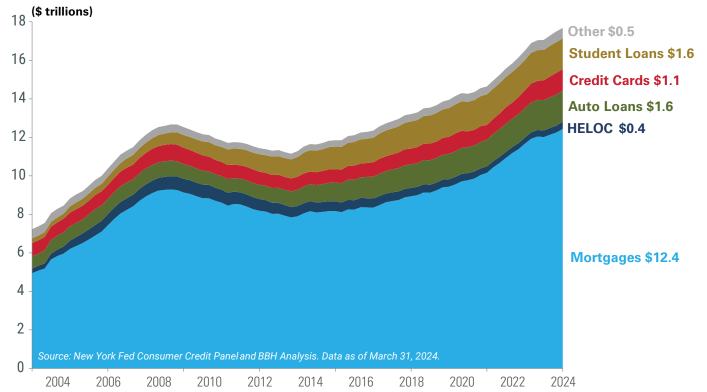
An imbalance between available supply and job openings still lingers, but the gap is narrowing rapidly: Over the first four months of 2024, job openings declined by 2.3 million, while 570,000 people returned to the labor market. Demand for employees is going down, while supply has started to rise.

At this pace, the labor market will come back into balance in the second half of the year, auguring rising unemployment, slower wage growth, and diminished job security. It would be a mistake to interpret this as cataclysmic for the labor market. It is, rather, a return to a more normal relationship between supply and demand, and therefore, a more modest underpinning for consumer confidence and spending.

Consumer Debt

If Americans like to spend, they also like to borrow. Total household debt stood at $17.7 trillion as of first quarter 2024 – up $3.5 trillion since just before the pandemic and up $6.0 trillion over the past decade.

Mortgage debt has been the fastest-growing category (up 23% since fourth quarter 2019), followed closely by auto loans (up 18%) and then credit cards (up 17%). Home equity lines of credit (HELOCs) is the only category to show a decline. In addition to growing incomes and the receipt of fiscal stimulus associated with the pandemic, households have been fueling their spending with rising debt levels as well.



This may look grim at first glance, but the picture is not quite as dire as the headline figures indicate. Yes, debt levels have risen sharply over the past decade, but household incomes and assets have risen even faster. The result is a deleveraging of household balance sheets despite the rise in absolute debt levels:

- Household debt to disposable income has dropped from 135% in 2007 to 97% today, a 23-year low.
- Debt to assets has dropped from a peak of 23.8% in 2009 to 12.5% today, a 49-year low.

Furthermore, because most mortgage debt in the United States is fixed, the rise in interest rates has been slow to hit households. According to the St. Louis Fed, 92% of outstanding residential mortgage debt is fixed. To the degree this debt was assumed or refinanced before the Fed started raising interest rates in 2022, homeowners aren't paying the prevailing rate of mortgage interest. Although the nationwide average rate for a 30-year fixed mortgage was 7.25% in late June 2024, the effective average rate actually paid by U.S. households was a far lower 3.78%.

As with the labor market, the news on consumer debt is one of marginal change, not radical dislocation. The economic risk here isn't that consumers suddenly become fiscally prudent and pay down debt levels – the risk is simply that they borrow at a slower rate going forward. This alone would be a brake on the pace of spending and economic activity.

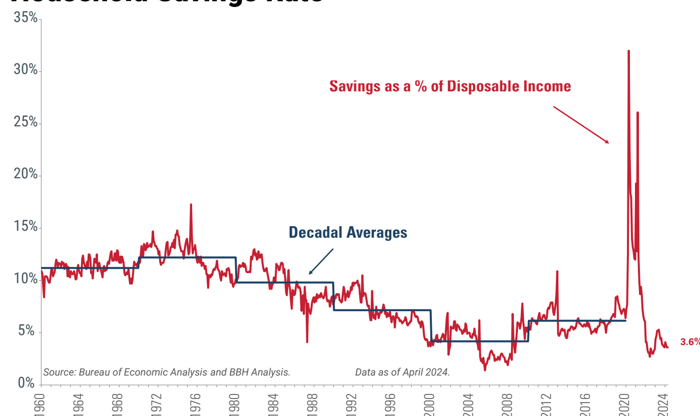
Personal Savings

The flipside of debt is savings: If *debt* is money spent but not earned, *savings* is money earned but not spent. Pandemic-era fiscal policy wrought havoc with household savings, as stimulus checks and other forms of

The resilience of consumer spending is impressive. Most analysts expected that 2023 would mark the long-awaited economic hangover from the trillions of dollars of fiscal stimulus that took place in the wake of the pandemic-induced recession. We're still waiting.

fiscal support were injected into the economy precisely at a time when consumers found it hard to spend (in traditional ways, at least) because of COVID-19 restrictions. As shown in the nearby chart, annual savings soared as high as $6.5 trillion, bolstering household finances but also sowing seeds for the inflationary excess consumption that followed.

Household Savings Rate



Annual savings are now back down to a more historically normal $1.5 trillion in absolute dollar terms, but because incomes have risen in the intervening period, the savings rate (savings as a percentage of disposable income) has dropped precipitously.

Decades ago, U.S. households saved 10% to 12% of their income (between 1960 and 1980), before dropping steadily to a low of 4.2% throughout the 2000s. Some of this secular decline is explained by the growing prevalence of two-income households, readier access to credit, and expanded unemployment insurance.

Perhaps predictably, savings rose in the wake of the global financial crisis (GFC), as the twin shock of the housing crisis and rising unemployment prompted Americans to save more. But now, as the fiscal policies of the pandemic recede further into the past, the household savings rate has dropped to a near-record low of 3.6%.

While this is not to say that some economic ill is sure to follow, there isn't much of a margin of safety in household finances if or when economic conditions deteriorate.

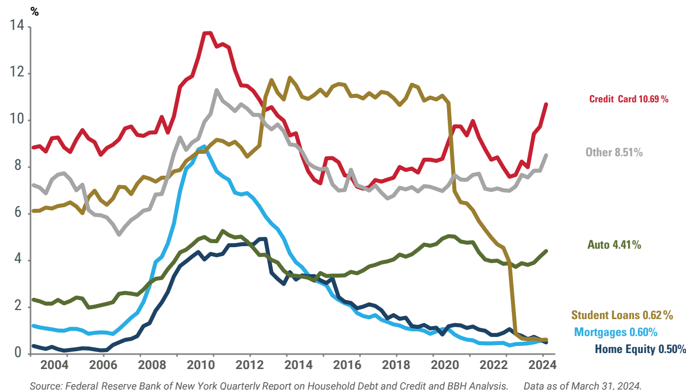
Debt Delinquencies

Take one part soaring debt, mix with a helping of lower savings, add a dash of elevated interest rates, and you've got a recipe for financial stress. Rising delinquencies offer the proof in the economic pudding – the evidence that this combination is finally affecting household finances.

The good news is that there are (as of yet) no signs of financial stress in the larger components of personal debt. The nearby graph breaks down serious delinquencies – outstanding debt over 90 days in arrears – by the same categories illustrated earlier in the graph of total debt levels.

> “ ”
>
> Modestly slower economic activity and falling interest rates form a benign backdrop for financial markets, although heightened volatility has historically accompanied pivots in monetary policy.

Percentage of Household Debt 90+ Days Delinquent



Source: Federal Reserve Bank of New York Quarterly Report on Household Debt and Credit and BBH Analysis. Data as of March 31, 2024.

The critically important category of mortgage debt shows no real signs of stress: Only 0.6% of outstanding mortgage debt is more than three months delinquent, a measure well below pre-pandemic and even pre-GFC levels. HELOCs are in even better shape.

The worrisome news is the sharp rise in credit card delinquencies over the past few quarters, as missed credit card payments are usually the early warning sign of household financial stress. A strapped borrower will skip a few credit card payments before missing a mortgage or car loan payment: The bank will repossess your car or foreclose on your home, whereas it's hard for a credit card company to come after you for all those Amazon purchases you made. Credit card delinquencies in first quarter 2024 topped 10% for the first time in over a decade, and we will be watching closely to see if this stress seeps into other categories of consumer debt.

Credit cards are the proverbial canary in the coal mine, and we're starting to worry about the canary.

What Comes Next?

There is little evidence that these incipient trends are weighing on economic activity at present. Real-time measures of economic activity remain robust. Two (nontraditional) economic measures indicate that discretionary spending is still healthy and that the weight of rising debt, diminished savings, and higher interest rates hasn't yet constrained spending:

- Passenger air travel in 2024 is up 6.5% vs. last year (through June 17).
- OpenTable dining reservations are up 3.5% year over year (through June 25).

We'll watch these and other real-time measures to assess when and how rapidly these headwinds to personal consumption begin to affect economic activity.

Economists and pundits love to debate whether any economic landing will be soft or hard, without ever really defining those terms. We won't offer a definitive definition here either, other than to observe that hard and painful landings in the past have typically coincided with the Federal Reserve mistakenly keeping interest rates too high for too long.

Inflation obviously plays an important role in determining monetary policy. The Fed's twin mandate is to implement policies that foster full employment (another ill-defined term) while maintaining price stability (a third ill-defined term).

Balancing these vague and often conflicting goals has been relatively easy over the past few years, as the Fed has focused on getting inflation down in a context of strong economic growth. Since last raising interest rates in July 2023, the Fed has maintained the position that there hasn't been enough further improvement in inflation to allow it to lower interest rates, and at the same time not enough economic challenges to require it to do so.

We believe that both of those calculations will change during the second half of 2024. Headline inflation has dropped from a peak of 9.1% in June 2022 to 3.3% in May 2024, while core inflation – a more important measure of endemic inflation – has dropped from a peak of 6.6% to 3.4%.

Neither are quite yet at the Fed's preferred level, but as shelter and insurance prices continue to revert to more normal levels, we should see further downside in core measures of inflation, enabling the Fed to respond to early signs of economic anxiety by gradually lowering interest rates. Our best estimate is that the Fed begins to cut interest rates later this year (probably after the November election), followed by more cuts in 2025.

Modestly slower economic activity and falling interest rates form a benign backdrop for financial markets, although heightened volatility has historically accompanied pivots in monetary policy.

As active investors, we consider price volatility our friend, as unpleasant as it may be in the moment, as volatility creates the disconnect between price and value that our analysts and portfolio managers seek to exploit.

In the longer run, our asset allocation strategies and portfolio positions are not predicated on any one economic outcome – or the timing of any particular outcome – but are instead focused on the longer-term needs of our clients and the fundamental returns on offer in specific asset classes and securities. ■

Asset Allocation and Beyond:

A Personalized Approach to Portfolio Construction

Justin Reed
Partner
Chief Investment Officer

Ilene Spitzer
Managing Director
Deputy Chief Investment Officer

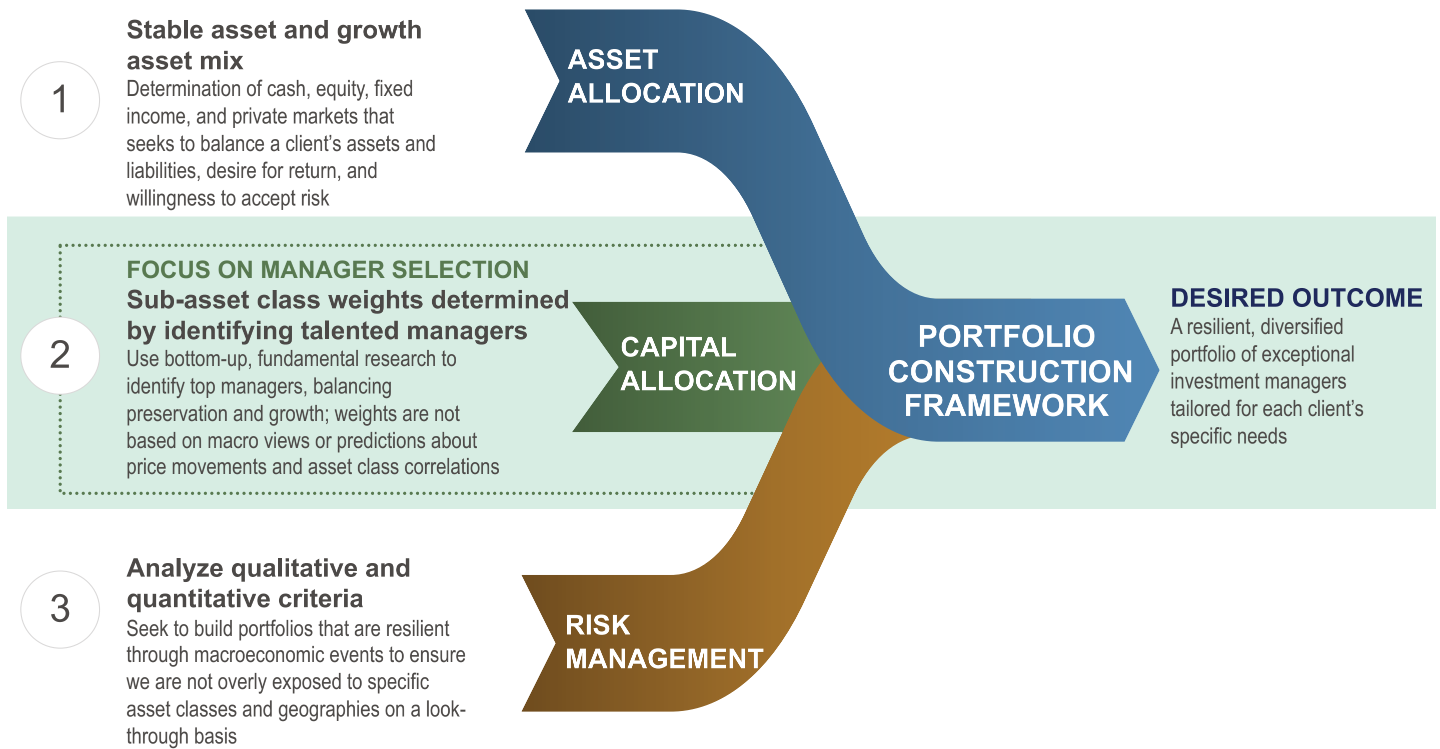
Niamh Bonus
Principal
Head of Client Portfolio Management and Strategy

At Brown Brothers Harriman (BBH), we are partners in our clients' success. We go the extra mile to ensure our clients achieve their goals and objectives, preserving and growing wealth along the way.

To do so, we must question and test common investment industry assumptions, with the idea that a rigorous application of "truth seeking" will allow us to generate better results for our clients. We have crafted sophisticated frameworks in our unique approach to portfolio construction to enhance the traditional asset allocation process.

A Unique Approach to Portfolio Construction

We invest bottom-up and worry top-down



BBH's Holistic Approach to Portfolio Construction

We believe in a multipronged implementation of several different allocation frameworks to achieve a balanced and resilient portfolio. The Investment Research Group (IRG) has frequently discussed our unique three-step approach to portfolio construction, which involves asset allocation, capital allocation, and risk management. Importantly, each of these elements incorporates additional second-order allocation frameworks, such as:

- Risk-return goals
- Objectives
- Liquidity needs
- Role in the portfolio
- Style

In this article, we describe how we use each of these allocation frameworks to construct custom portfolios that meet each client's risk/return objectives, as well as goals and liquidity needs. The above chart depicts how these frameworks all inform BBH's portfolio construction process.

"We believe in a multipronged implementation of several different allocation frameworks to achieve a balanced and resilient portfolio."

Asset Allocation

Most in the investment industry think of asset allocation as using techniques such as mean-variance optimization (MVO) to bucket portfolios among different sub-asset classes based on top-down macroeconomic and financial market variables.

However, we define asset allocation as the process of selecting the optimal mix of cash, public equities, fixed income, and private investments that best balances a client's goals, objectives, liquidity needs, and risk tolerance.

Determining a client's investment goals and objectives is a critical step in the portfolio construction process. Considerations we assess for each client include:

> *"It is worth noting that these three components of asset allocation - returns, objectives, and liquidity - should not be viewed in isolation. Rather, it is the combination of them all, and the conversations they foster, that facilitate great portfolio construction."*

FINANCIAL SITUATION

- Current balance sheet – assets and liabilities
- Income, expenses, savings, debt
- Liquidity needs and outflows
- Legacy or estate planning goals

RISK TOLERANCE

- Tolerance for significant market downturn
- Comfort level with short-term portfolio price movement of 10% to 30% of its value
- Expected annual return on investment

INVESTMENT GOALS

- Long-term financial goals
- Focus on capital growth, income generation, solely capital preservation, or a combination of these
- Purpose of investment assets
- Investment time horizon
- Income needs

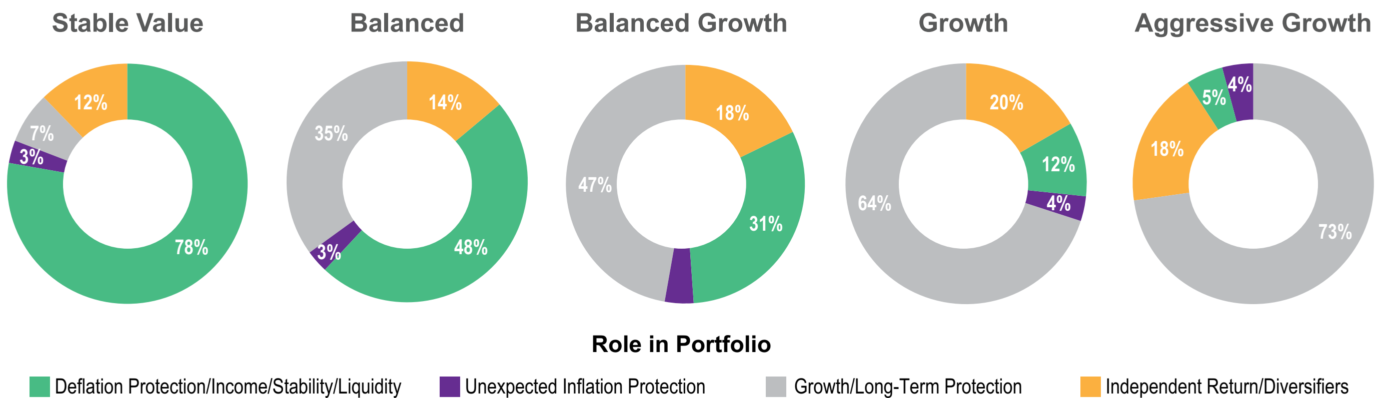
PREFERENCES AND CONSTRAINTS

- Any investment preferences or restrictions
- Existing exposures of significance, such as real estate, private business ownership, or other
- Potential emergency liquidity needs
- Specific tax considerations to be accounted for

These considerations can further be refined to several second-order allocation frameworks:

- Risk-return goals
- Objectives
- Liquidity needs

BBH Policy Portfolios[1]



[1] BBH Policy Portfolio reflects portfolio types for Domestic, Qualified, Taxable Investors. In addition, BBH offers portfolios for non-qualified, tax-exempt, endowment and foundation, and customized portfolios for each individual client. Data as of June 20, 2024.

Risk-Return Goals Allocation

Risk-return goals-based allocation is often used in conversations involving one's investment policy statement (IPS). BBH manages investment portfolios that span the spectrum of risk tolerance and return objectives.

For example, our Stable Value portfolios – which seek to support both current and future spending needs by focusing on income, liquidity, and total return – are composed largely of fixed income and cash, with small allocations to equities and private investments.

On the other side of the spectrum, our Aggressive Growth (or All-Equity) portfolios, which seek to preserve and grow purchasing power by employing an approach focused predominately on capital appreciation, are made up largely of public and private equity exposure.

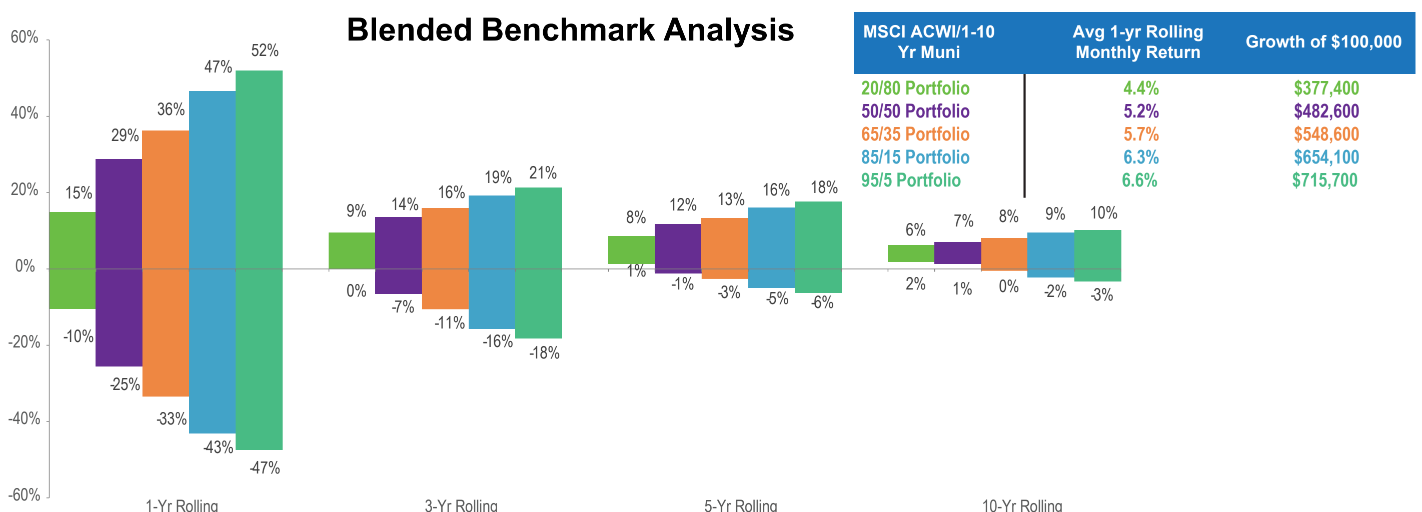
A risk-return goals-based allocation facilitates conversations around potential trade-offs between expected returns and several different definitions of risk. We often share charts like the one below to engage our clients in "what-if" scenarios, which helps us better align their portfolios with their true return objectives and risk tolerance.

An asset allocation comprising 95% equity and 5% fixed income (solely using index performance) has experienced annual returns that range from 52% to -47%. Clients who are unwilling to potentially incur such volatility should consider portfolios with lower equity exposure.

It is worth noting that in order to complement equity and fixed income, we source private market investments to enhance overall performance, increase diversification, and reduce portfolio risk.

We do look to analyses such as MVO to help inform risk-return allocation, but we emphasize that it is just one of many different considerations that should inform one's overall portfolio construction.

Blended Benchmark Analysis



MSCI ACWI/1-10 Yr Muni	Avg 1-yr Rolling Monthly Return	Growth of $100,000
20/80 Portfolio	4.4%	$377,400
50/50 Portfolio	5.2%	$482,600
65/35 Portfolio	5.7%	$548,600
85/15 Portfolio	6.3%	$654,100
95/5 Portfolio	6.6%	$715,700

Data as of May 31, 2024.
Source: Bloomberg.

Based on annualized rolling monthly returns since December 31, 1987.

Objectives Allocation

Objectives-based allocation can also help refine a client's portfolio, with separate return and risk goals for each objective. Objectives can include:

- Spending
- Philanthropy
- Retirement
- Opportunistic capital (e.g., cash intended for once-a-decade opportunities)
- Inheritance

Such allocations help increase the probability that a portfolio will meet a client's goals and objectives, as success is often multidimensional and reflects more than one objective.

Liquidity Needs Allocation

Liquidity refers to the ability to convert an investment to cash without affecting its market price. The determination around a liquidity needs allocation framework is often closely related to a client's assets and liabilities, age, and time horizon.

For example, a young client with few liquidity needs and a long time horizon could choose to invest a large percentage in relatively illiquid investments, whereas a client with large upcoming liquidity needs would be advised to have a higher allocation to cash and fixed income by comparison.

Our liquidity needs allocation breaks down all of the underlying investments by liquidity classification (for example, highly liquid, liquid, and limited liquidity), which allows us to ensure that our clients' liquidity needs are met. Liquidity stress testing the portfolio can provide enhanced comfort that the desired liquidity will be available in potential times of stress.

It is worth noting that these three components of asset allocation – returns, objectives, and liquidity – should not be viewed in isolation. Rather, it is the combination of them all, and the conversations they foster, that facilitate great portfolio construction.

Capital Allocation

Capital allocation, or manager selection, involves identifying exceptional investment managers capitalizing on market inefficiencies.

We do not set targets for sub-asset classes based on macroeconomic views or predictions about price movements and asset correlations. Instead, sub-asset class weights are largely determined by our long-term conviction in specific investment managers.

This bottom-up approach to sub-asset class weights prevents us from forcing capital into a sub-asset class where we cannot find a manager that meets our rigorous standards. All investment opportunities must compete for capital against all other opportunities regardless of sub-asset class.

Our approach to capital allocation allows us to generate additional *alpha*[1] for our clients. The scale to which the traditional asset class approach is practiced often causes market inefficiencies that allow us to find overlooked, yet exceptional, investment managers.

For example, many U.S.-based advisors use a U.S./international equity construct that implicitly removes global strategies (that is, strategies that can invest in both the U.S. and internationally) from consideration. A flexible mandate that invests in both the U.S. and internationally allows us to partner with managers who do not fit squarely into commonly used classifications. Accordingly, we have found an attractive universe of such managers who have typically been overlooked as an accident of traditional asset allocation structuring.

We believe that our approach to portfolio construction, which is similar to many of the top-performing endowments and foundations, provides a richer universe of opportunities, resulting in a high-quality portfolio that best optimizes return for a given level of risk.

To underscore this, we turn to Howard Marks, co-chairman of Oaktree Capital and the former investment committee chair at the Metropolitan Museum of Art's endowment:

- A common perception of risk illustrates the risk-return trade-off where lower risk equates to lower potential return, and higher risk equates to higher potential return. Marks suggests that this is often erroneously taken to imply that "riskier investments produce higher returns."
- Instead, we look at the relationship between risk and return where, in Marks' words, "the return of each investment is shown as a range of possibilities, not the single outcome suggested by the upward-sloping line.

Our capital allocation process demands that we partner with top-quartile managers who can drive outcomes such that they land in the top half of a distribution for a given level of risk. Effectively, our approach to capital allocation is focused on achieving higher returns while holding risk constant by partnering with the world's best investors.

While the majority of our efforts in capital allocation relate to the aforementioned processes, there are a couple of second-order capital allocation frameworks that are worth highlighting:

- Role in the portfolio
- Style

Role in the Portfolio

We categorize investments into four different categories by the role they play in the portfolio. This allocation framework ensures that we focus on more than just the underlying assets and look at the role we expect the strategy to play in the portfolio.

- **Public and private equity provide growth and long-term inflation protection.** Many investors understand intuitively that public equities should provide growth in one's portfolio, but the long-term inflation protection benefits are often underappreciated. Since 1926, the S&P 500 has annualized at 9.8% on average, while inflation has grown at a 3% average rate over the same time.

  We focus on investing in high-quality companies that have pricing power, which implies that they can raise prices faster than the underlying rate of inflation by passing on price increases to customers. We believe that this provides our clients with more attractive growth and long-term inflation protection. As we have long said, the best hedge against inflation over the long term is high-quality equities.
- **Real estate, or opportunistically, Treasury inflation-protected securities (TIPS), provide short-term inflation protection.** Within our real estate portfolio, the majority of our assets are multi-family housing, where rents generally adjust every 12 months to increase in line with, or in excess of, inflation spikes. The American Housing Survey shows that during the inflationary period between 1973 and 1983, median multi-family rent expanded at an average rate of 8.5% and easily outpaced relative inflation.
- **Cash and fixed income provide deflation protection, stability, liquidity, and/or yield.** These roles are particularly useful but must be balanced with the fact that cash and most fixed income investments do not provide long-term inflation protection. In other words, a portfolio of only

[1] *Alpha is the amount by which a strategy has outperformed its benchmark, taking into account the strategy's exposure to market risk (Source: Morningstar).*

cash and fixed income, while providing stability, is unlikely to preserve real purchasing power over time.

In the 15 years following the great financial crisis, fixed income and cash investors also did not provide the yield that investors sought. However, the post-pandemic interest rate regime has resulted in a higher interest rate environment that is finally providing investors with more attractive yields.

- **Private debt, distressed, alternative credit, insurance, and other nontraditional opportunities provide independent return or diversifying exposures.** Importantly, these assets should be capable of generating public equity-like returns with low public equity *beta*.[2] We look to returns in this category to be driven largely by *alpha*, which by definition is idiosyncratic, and therefore diversifying.

Style Allocation

While we spend a lot of time selecting a concentrated group of exceptional investment managers on a bottom-up basis, that alone is insufficient capital allocation.

We also classify our managers by style characteristics – such as value-oriented, core, quality compounders, and high growth in our public equity portfolio. This allows us to better understand how the portfolio's underlying investments will work together to maximize return and minimize risk.

- **Value-oriented/mature:** These managers tend to have a relatively stricter valuation discipline, owning more lower-growth businesses that generate a higher current free cash flow yield. Many of these companies are in more mature industries.
- **Core:** These managers tend to be valuation sensitive and own more stable or modest growth businesses.
- **Quality compounders:** These managers typically target mid-teen returns or above and have long time horizons, although such managers tend to be slightly less valuation sensitive than core and value-oriented managers. The underlying businesses tend to be predictable with above-average growth profiles.
- **New economy/high-growth:** These managers tend to exhibit higher tracking error relative to benchmarks, more upside potential, greater volatility, and higher long-term return expectations.

Risk Management

The final step in our portfolio construction process is risk management. Given our focus on bottom-up selection and unwillingness to fill asset class buckets with inferior managers, we insist upon a rigorous application of risk management. This approach ensures there are no unintended consequences of our previous portfolio construction-related decisions and that we capitalize on short- and medium-term market inefficiencies through opportunistic portfolio adjustments.

To address unintended consequences, we employ a top-down risk management overlay designed to avoid unintended risk exposures by analyzing a range of different qualitative and quantitative criteria.

Risks are usually viewed as threats to wealth preservation and growth, but they can also highlight opportunities that we can capitalize on through opportunistic portfolio adjustments. For example:

- During the COVID-19 pandemic, we had a short-duration bias within our fixed income portfolio, which was rewarded when the Federal Reserve started raising rates in March 2022 and longer-duration fixed income sold off. "Cash was not trash" in this environment, and we took advantage by purchasing securities with high yields and very low risk.
- More recently, with rate cuts more likely than rate increases, we have been extending duration at the most attractive parts of the yield curve, locking in attractive yields for longer time horizons.
- We also look to make such portfolio adjustments outside of the fixed income portfolio. For example, prior to the pandemic, our team recognized potential company distress in several markets and opportunistically partnered with an exceptional distressed debt manager that successfully capitalized on the distressed opportunities in 2020 and 2021.

Public Equity Manager Style Characteristics

	Value-Oriented/ Mature Businesses	Core	Quality Compounders	New Economy/ High-Growth
Downside Protection	More ◄		►	Less
Upside Participation	Less ◄		►	More
Volatility of Returns	Less ◄		►	More
Long-Term Return Potential	Lower ◄		►	Higher

[2] *Beta is a measure of a portfolio's sensitivity to market movements. The beta of the broader equity market, as measured by the S&P 500, is 1.00 (Source: Morningstar).*

> *Rebalancing, at its core, is an exercise in risk control, in that it keeps a client's portfolio in line with desired allocation ranges."*

- Today, we are acutely aware of the threats and opportunities surrounding artificial intelligence (AI). We have positioned our public equity portfolio to overweight companies that should benefit from the rise of AI rather than those that may be disrupted. We have also allocated more capital to an exceptional venture capital manager that has been a leader in AI for over a decade.

Capital Impairment

Chief among the myriad risks investors must consider is permanent capital impairment. What is difficult about this is that "permanent" is often indistinguishable from "temporary." From time to time, the fundamentals of our underlying investments will become disconnected from how they are priced in the market. Price is not value.

The key is to have the confidence to stick with your investment manager during periods where prices are lagging the fundamental performance of the underlying assets. Temporary price underperformance during a period of fundamental asset performance is actually an opportunity to buy (or hold) assets on sale, which, research has shown, will reflect fundamental performance in the long run.

Downside Returns

Because our approach to portfolio construction incorporates several dimensions, we also monitor risks such as "the risk of falling short." It is human nature to focus on downside risk. Indeed, behavioral economics makes it clear that losses of the same amount as gains are felt 2.25 times as much.[3]

Yet we also understand that for many of our clients, not having the necessary assets or liquidity at the right time is also a risk that warrants much consideration. As such, it is imperative to understand the downside return potential for any relevant portfolio over a certain period of time. Without this "worst-case scenario" visualization, a client could end up without sufficient cash for spending needs or wealth for future generations, for example.

Rebalancing

Rebalancing is the final leg of our risk management approach. We generally encourage thoughtful rebalancing, which incorporates tax considerations where appropriate, to ensure optimized long-term results. Rebalancing is, at its core, an exercise in risk control, in that it keeps a client's portfolio in line with desired allocation ranges.

Importantly, our approach to rebalancing requires that we know the fundamental performance of our portfolio, not just the price performance. We spend a lot of time monitoring the valuation and fundamental performance of our portfolio (and the underlying managers and assets) relative to various benchmarks. This allows us to rebalance in a targeted way that can add value to long-term results.

For example, when a manager has generated higher earnings, better margins, and higher cash flow than a relevant benchmark but has underperformed, we may suggest adding capital to that manager and moving some away from one that has exhibited price increases in excess of its fundamentals. Tax impact must be considered where necessary, but we have found that such data-informed rebalancing can enhance after-tax portfolio results.

Conclusion

Our approach to portfolio construction is multifaceted and client-specific. We believe that leveraging our unique three-step approach to portfolio construction – which involves asset allocation, capital allocation, and risk management, with additional second-order asset allocation frameworks built into each layer – is the surest way to generate long-term success for our clients while mitigating risk.

We look forward to continuing to be partners in your success, tailoring our unique allocation frameworks to help you best meet your goals and objectives. ■

[3] *Kahneman, D., & Tversky, A. (1979). Prospect Theory: An Analysis of Decision Under Risk," Econometrica, XLVII (1979), 263-91.*

Setting an Asset Allocation for Endowments and Foundations

By Suzanne Brenner
Partner

Ilene Spitzer
Managing Director
Deputy Chief Investment Officer

Endowment and foundation (E&F) trustees and management teams understand that one of their most important responsibilities is to prudently invest the institution's assets.

Setting an appropriate asset allocation is critical to achieve that goal. Asset allocation should be carefully documented in an investment policy statement (IPS) and reviewed regularly.

Here, we explore the special considerations that are key to successful asset allocation for E&Fs, including:

- Risk/return considerations
- Spending policies
- Liquidity needs

We also discuss private investments – why and when to include them in a portfolio and how much of an allocation is appropriate.

Setting an Asset Allocation

David Swensen at Yale University popularized the "endowment model," and many E&Fs have since adopted it. This asset allocation model seeks to maximize returns by focusing on partnerships with exceptional managers who can take advantage of inefficient markets and capitalize on the long-term nature of most nonprofit institutions.

This approach results in asset allocation outputs that favor alternatives, including private equity, venture capital, and real assets, as well as public equity and hedge funds, while allocating very little to fixed income and cash.

While it is tempting to replicate a model that has worked so well for Yale and other large endowments, rather than simply following this investment strategy, one should consider an institution's unique factors, needs, and preferences when setting an asset allocation.

The primary objective of an E&F investment portfolio is to maintain its purchasing power so that support for the operating budget keeps pace with inflation over time.[1] Such an objective facilitates "intergenerational equity," ensuring that the same level of spending is available to future generations.

Trustees and management are responsible for setting an asset allocation that provides the best chance of achieving both goals of supporting the operating budget today and maintaining purchasing power into the future.

It would be easy if there was one asset allocation that worked for all E&Fs. Unfortunately, there is no "one-size-fits-all" solution, as setting an asset allocation requires an understanding of each institution's unique attributes.

Some factors will be weighed more heavily by one institution over another. Spending policies and needs, liquidity position, and the overall financial health of an institution are all important factors in determining what level of price volatility would be tolerable and what level of investment returns are required to maintain the purchasing power of the institution in perpetuity.

Risk/Return Trade-Off

An appropriate asset allocation involves balancing return objectives with risk tolerance. At the most basic level, when setting an asset allocation, a client's return objective is met with growth- or equity-oriented investments, while risk is largely controlled by investing in high-quality fixed income and cash investments.

In a vacuum, it would make sense for an E&F to invest the majority of its investment portfolio in growth assets – both public and private equity – in order to maximize the value of its endowment in the long term. But such a decision would likely result in substantial short-term volatility, which could reduce spending from the endowment during a period in which equities decline, or risk a permanent impairment of capital from selling risk assets at the bottom of the market.

If an E&F prioritized generating income to meet its spending needs, it might invest mostly in fixed income. That decision, while significantly reducing volatility, would likely result in the portfolio's spending power declining over time by not keeping pace with the spending rate plus inflation.

Finding the right balance between equity and fixed income is a first priority, but setting an asset allocation for an E&F is more nuanced than this simple example. As shown in the nearby graphic, asset classes play different roles in a portfolio, and the long-term target allocation for each asset type is established based on the role it can play.

Combining asset classes that have different return drivers and therefore perform differently in various market environments (that is, *diversifying* the portfolio) is a prudent risk management strategy that is key to meeting long-term investment objectives while dampening volatility. For example:

[1] *The exception to this rule is when an E&F will not last in perpetuity but has a finite life.*

- Independent return strategies such as private debt or distressed investments can provide excellent returns that are not dependent on equity or fixed income market performance.
- Adding real estate or Treasury inflation-protected securities (TIPS) can protect the portfolio in periods of unexpected inflation.
- To benefit from an illiquidity premium and further enhance returns, a private equity allocation can be additive. (A deeper discussion of private equity is set forth later in this piece.)

Diversifying a portfolio's equity and fixed income allocations across positions, regions, and sectors is also important. For example, if several managers have significant overlapping positions, the portfolio may not be as diversified as one might otherwise assume. Doing a proper look-through analysis and understanding these concentrations is critical to manage risk.

One of our highest-conviction managers illustrates diversification well. He asks two questions that must be answered together:

1. **Do you believe in diversification?**
2. **Are you disappointed if one part of your portfolio has losses when others are positive?**

If the answer to the first question is yes and the second is no, you do not believe in diversification. It is important to discuss with an investment committee what diversification truly means so that expectations are properly managed.

Risk Tolerance

Many institutions think they can stomach short-term volatility. In reality, when a market downturn occurs, management and trustees often decide they can no longer hold onto declining investments, and they sell at exactly the wrong time.

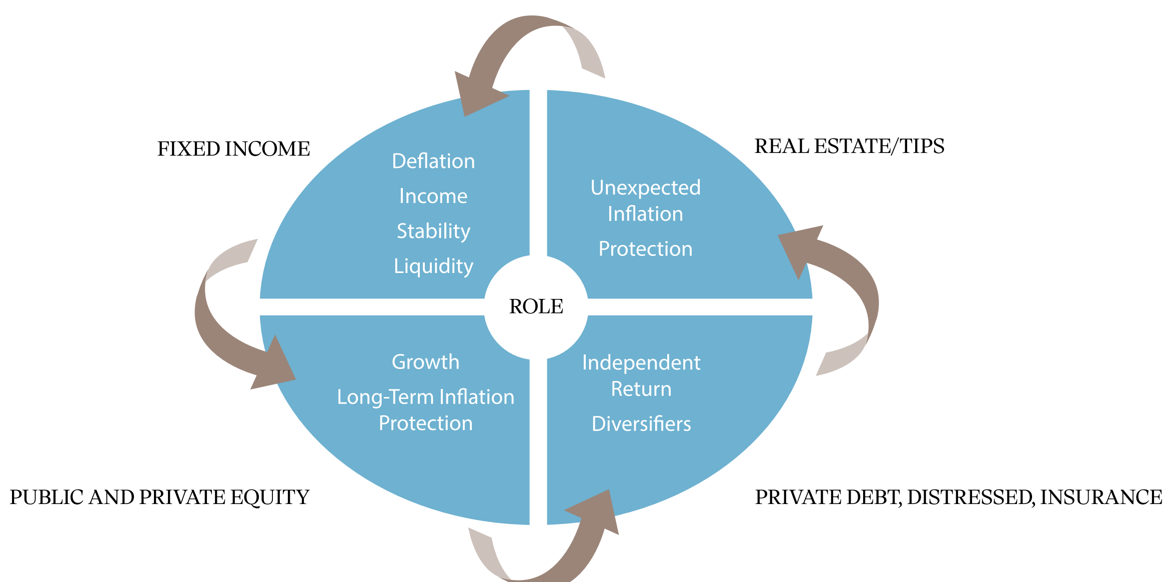
Running stress tests and scenario analyses to understand what those return patterns could look like – and what those declines translate to in dollar terms – helps educate stakeholders and ensures that no one is surprised in a downturn.

Setting appropriate return and risk expectations can help the institution to not only hold on to investments during a market correction, but also add when valuations are particularly compelling. Opportunistic rebalancing – and in particular, rebalancing without tax implications – is one of the greatest levers that nonprofit institutions can utilize to enhance returns.

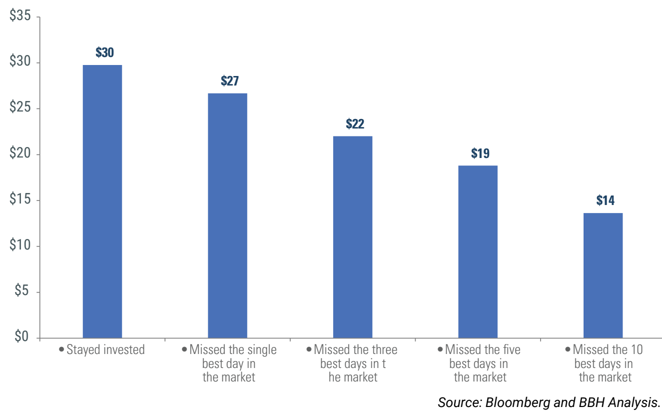
It is never easy to stay invested when markets are declining. We have seen even very sophisticated investors sell out of equities during periods of market panic, such as the global financial crisis and COVID-19. However, as shown in the nearby chart, it is nearly impossible to time the market successfully. You might make the right call to exit the market, but you will inevitably miss the market recovery.

The following chart presents the return of the S&P 500 over the past 34 years compared with the return if you simply missed the 10 best trading days. The return difference is staggering. Unfortunately, no one can consistently predict when downturns will occur, or when the market will rebound, so the best approach is to remain invested according to your long-term asset allocation and rebalance.

Finally, while we highlighted volatility as an important risk, one must be mindful of other risks in the portfolio. Factors such as appropriate leverage levels, derivatives use, duration in fixed income, position and sector concentration, and fees should be agreed upon and documented.



Hypothetical Growth of $1 Invested in S&P 500 from January 1990-May 2024



Spending Policies

Another important consideration in setting an asset allocation is determining an institution's spending needs and its reliance on its endowment to meet those needs. These spending requirements translate into the institution's spending rate (dollars spent out of the endowment divided by the endowment's net asset value).

A higher spending rate generally necessitates a higher required rate of return to maintain purchasing power over time. However, a higher spending rate can also result in an institution that is unable to tolerate endowment volatility.

All institutions should set an appropriate spending policy (that is, a plan that governs how much of the organization's long-term assets can be used each year). Choosing the right policy for your institution is critical to maintaining the balance between current and future spending needs.

For a deeper discussion on the various spending policies and the considerations around choosing from three general approaches – steady growth, target percentage, or a hybrid of the two – please reach out to your Brown Brothers Harriman (BBH) relationship manager.

The percentage of the institution's budget that is supported through endowment spend should also be considered. In general, if the amount of endowment support is relatively low (that is, 15% to 20%), and there are many other sources of income that can be relied upon for spending (for example, operating revenues, gifts, etc.), then the portfolio might be able to tolerate more risk and short-term volatility to achieve a higher return.

In contrast, if the endowment is the sole source of support for the budget, it may be more appropriate to achieve a balance of growth assets and diversifiers/fixed income, as a significant decline in the endowment could make it difficult for the institution to fund its current expenses.

Planning for the steps an E&F can take in the inevitable situation when the market – and therefore, spending from the endowment – declines is a prudent exercise. Key questions include:

- Can the institution cut expenses if necessary?
- Are there other sources of income that can be tapped in a downturn (for example, gifts or lines of credit)?
- Is there debt that must be serviced?
- Is there a rating on the debt that must be maintained?

In all cases, it is important to consider the financial health of the institution as a whole to establish an asset allocation that allows for staying power during a downturn so that the long-term return objectives can be met.

Unfortunately, many E&Fs set their asset allocation without considering the spending needs required from the endowment. Consider the following: An institution invests its portfolio across a mix of asset classes that is expected to generate a long-term nominal return of 7.5%. If inflation is expected to average 2% over time, the appropriate spending rate would be 5.5% or less to maintain the purchasing power of the institution's portfolio.

However, if the institution is uncomfortable with the risk profile of a portfolio that seeks to generate a 7.5% annualized return over time (that is, one that favors equity over fixed income), and instead invests its portfolio in a more balanced equity/fixed income mix, then spending at 5.5% will likely fail to maintain the portfolio's purchasing power, as the investment portfolio will be unlikely to earn a real return in excess of the spending rate. In this situation, a lower spending rate would be more appropriate.

Liquid vs. Illiquid

Different asset classes provide varying amounts of liquidity, from cash that is completely liquid to private equity investments, which typically have fund lives of more than 10 years.

Even public equities, which can usually be sold quickly, should not be counted on for liquidity needs, as one of the worst outcomes is the permanent impairment of capital that comes from selling equities in a market downturn to fund current cash needs.

When establishing an asset allocation, it is imperative to forecast cash flow needs so that the portfolio will have enough liquidity to meet its obligations for operating expenses, nonoperating expenses (such as interest payments on debt, capital expenditures, and so forth), and capital calls for private investments.

We believe that carefully selected private investments can boost portfolio returns, as investors are provided with an illiquidity premium to lock up their money. However, all private investments are not created equally and should only be made if the following criteria are met:

- The investor is getting an adequate illiquidity premium.
- There is an internal team or external advisor that can identify top-tier private investment managers.
- The organization can properly handle the capital call and distribution activities from an operational perspective.

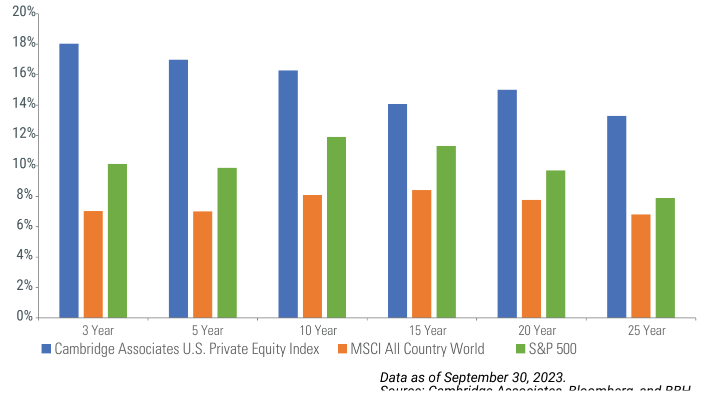
Private Investments: Why, How, and How Much?

As discussed, if an institution can take on illiquidity within its investment program, private funds have historically added value over public markets, earning a consistent illiquidity premium over time.

A 2015 Cambridge Associates study, "The 15 Percent Frontier," analyzed data amassed since the 1970s to conclude that E&Fs with higher allocations to private investments achieved stronger long-term returns with remarkable consistency year after year.

The following chart compares Cambridge Associates U.S. private equity pooled returns with public market benchmarks (S&P 500 and MSCI ACWI) over multiple time periods. Private market returns have consistently outperformed by a significant margin.

U.S. Private Equity Index Returns



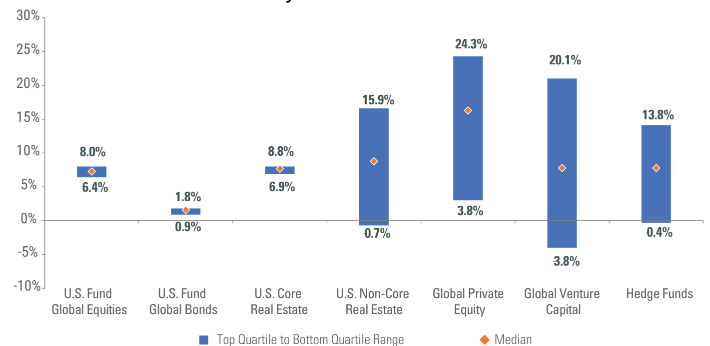
We have seen the outperformance of private investments in our own portfolios at BBH, where real estate, distressed debt, private debt, and private equity funds have all outperformed their relevant public market benchmarks.

Manager selection can be particularly additive in private markets, as there tends to be greater dispersion of returns vs. traditional markets and more persistency bias, with the strongest managers consistently outperforming.

For example, as seen in the nearby chart, for the 10-year period ended September 30, 2023, there was over a 20% spread between top- and bottom-quartile private equity funds (24.3% vs. 3.8% net IRR) vs. a spread of less than 1% between top- and bottom-quartile U.S. global equity funds.

Public and Private Manager Dispersion

Based on returns over a 10-year window



Source: J.P. Morgan Asset Management. Global equities (large cap) and global bonds dispersion are based on the world large stock and world bond categories, respectively.

Manager dispersion is based on the annual returns for U.S. fund global equities, U.S. fund global bonds, hedge funds, and U.S. core real estate over a 10-year period ending Q4 2023. Non-core real estate, global private equity, and global venture capital are represented by the 10-year horizon internal rate of return ending Q3 2023. U.S. fund global equities and bonds comprise U.S.-domiciled mutual funds and ETFs.

How much of the portfolio should be allocated to private investments? To answer this question, several others must be answered in turn.

- **First, how much incremental return does the institution need to meet its return objective?** Since private equity is added to provide a return premium to public equity, a greater allocation may be justified to support a higher spending rate.

- **Second, how much cash flow is needed for spending, and is there enough liquidity in other parts of the portfolio?** If the portfolio is invested in many hedge funds with lockups, small-cap equities that do not trade as easily, or other assets that have lower liquidity, private equity might be appropriate at a lower level (for example, 5% to 15%), or not at all. If there is an adequate level of cash and fixed income and few other calls on the endowment, the institution might be able to have a higher allocation (for example, 25% to 30%).
- **Finally, what is the mix of private investments, and what are the expected distribution and income characteristics?** There are different private investment asset classes, including real estate, private credit, and private equity. A private investment portfolio composed of predominantly private credit has a different liquidity profile than one entirely composed of venture capital, for example.

Larger institutions generally have a greater allocation to private investments compared with smaller institutions. A Mercer study from 2023 found that allocations to nontraditional asset classes (asset classes excluding developed market equities and bonds) were strongly correlated with the size of investment portfolios. For example, 63% of the institutions surveyed with portfolios over $1 billion had an allocation to private equity funds relative to 33% of portfolios under $100 million and just 12% of those under $50 million.

A recent NACUBO survey found that endowments with more than $1 billion in assets allocated nearly 30% of capital to private capital (private equity and venture capital collectively), whereas those institutions surveyed with $500 million to $1 billion in assets had an average allocation of 18%. Institutions below $100 million generally had less than a 5% allocation.

This same study found that, consistent with recent years' surveys, the largest endowments outperformed, which was largely driven by their substantial exposure to private equity and venture capital.

The pattern of larger institutions maintaining greater private capital exposure likely exists because larger organizations have the resources and skill sets to identify, monitor, and record the activities that are required for these types of investments.

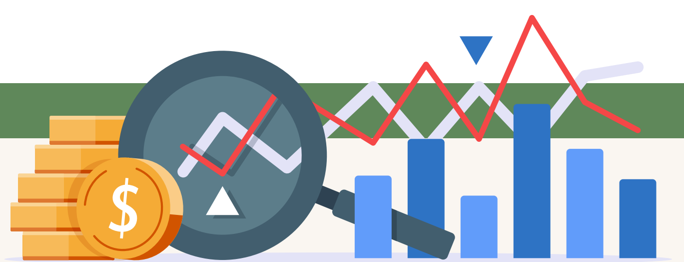
Lastly, in building an allocation to private investments, it is important to note that it takes time, as vintage year diversification is an important first principle of prudently investing in privates. BBH recommends using an annual private investments "budget" to consistently allocate across vintage years, with the goal of reaching and maintaining the long-term target asset allocation.

Creating an IPS

The final stage of the asset allocation process is to codify all of these carefully made decisions in an IPS. An IPS should include:

- The portfolio's long-term return objectives
- The policy asset allocation targets and ranges around these targets
- Policy benchmarks
- Risk levels
- Time horizon
- Liquidity provisions
- Spending needs
- The parties responsible for ensuring adherence to these policies

Inevitably, the institution's needs and market environment will change. Therefore, the asset allocation should be reviewed at least annually, along with the other components of the IPS, and any changes should be documented and approved. If you have any questions about setting up your institution's IPS, please reach out to your BBH relationship manager. ■



For example, to achieve a target private allocation of 25% as a BBH client (optimized for our unique private investments program), a commitment pace of 5% to 6% per year is generally recommended. Committing to an annual private investments budget can also assist with the timing challenges associated with private investing. The highest-caliber private fund managers are often oversubscribed and therefore have a very short fundraising period. The governance structure of many nonprofit institutions , with quarterly investment committee meetings, can prove challenging for committing to private funds in a timely manner. These timing challenges require that the investment committee has bought into the concept of recommitting to a private investments program year after year.

What We Believe: **BBH's Approach to Fixed Income Investing**

Tom Brennan
Vice President
Fixed Income Product Specialist

At Brown Brothers Harriman (BBH), our Fixed Income team has generated industry-leading results across taxable and municipal strategies for over a decade. These results arise from a team and process that has proven effective through a multitude of market environments.

Everything we do – the way we structure our team, screen our universe, conduct credit research, apply buy and sell disciplines, and construct portfolios – is undertaken systematically with the objectives of preserving our clients' capital and identifying value.

Our approach is rooted in two long-standing market features that create abundant opportunities for a valuation-driven manager:

- The additional yield provided by credit instruments is typically greater than their default costs.
- Bond valuations are usually much more volatile than their underlying fundamentals.

These features lead to several investment implications:

- First, bottom-up execution is paramount.
- Second, valuations and fundamentals should be assessed consistently.
- Third, a disciplined investor owns attractive assets when compelling credit opportunities are in short supply.
- Fourth, do not bet on unknowable criteria like the direction of interest rates.

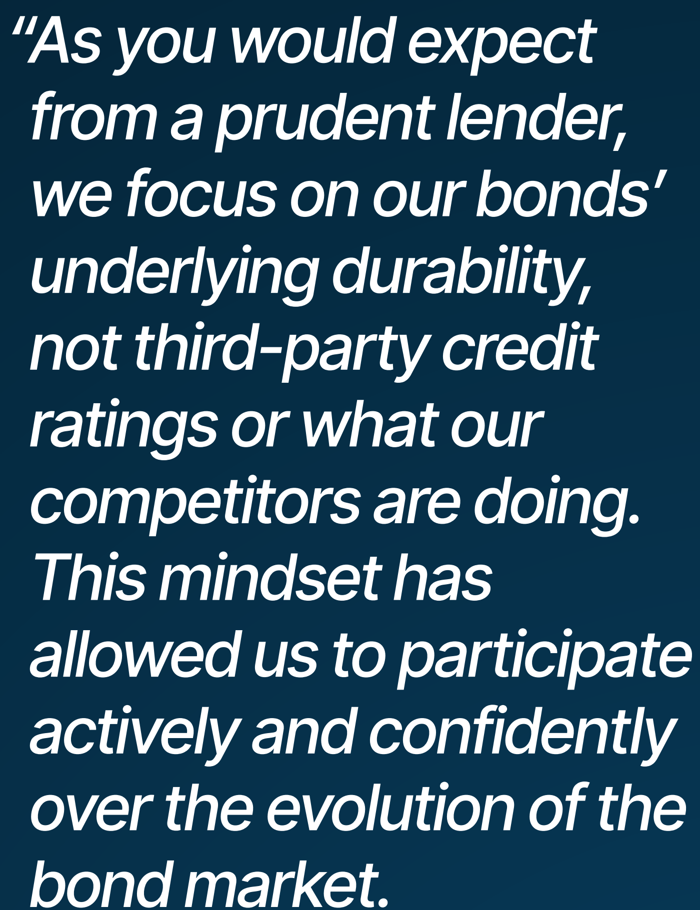
Our fixed income process leans deeply on BBH's long lending tradition and aligns with our clients' interests. As you would expect from a prudent lender, we focus on our bonds' underlying durability, not third-party credit ratings or what our competitors are doing. This mindset has allowed us to participate actively and confidently over the evolution of the bond market. BBH has participated in dozens of new structures in the municipal, corporate, and asset-backed credit markets, as well as countless inaugural issuances.

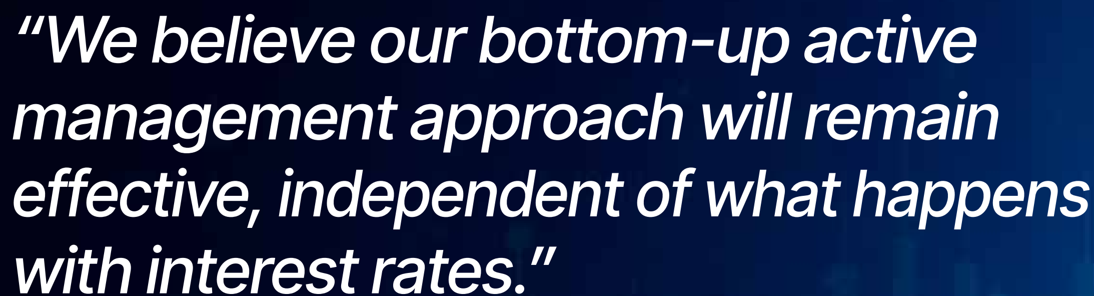
In this article, we cover the pillars of our investment philosophy that seeks to drive consistent performance through a variety of markets.

1. Bottom-Up Execution Is Paramount to Realizing the Benefits of Active Fixed Income Management

We build our portfolios one bond at a time, and our investment process focuses on a careful evaluation of each investment. At BBH, our analysts and traders are empowered like no other firm we know.

Each credit position (meaning a bond or loan that can default) must exceed our valuation threshold and is thoroughly researched, presented to the entire team, and approved unanimously by portfolio managers before purchase. Every position in every client portfolio results from this process.


"As you would expect from a prudent lender, we focus on our bonds' underlying durability, not third-party credit ratings or what our competitors are doing. This mindset has allowed us to participate actively and confidently over the evolution of the bond market.



2. Credit Valuations and Fundamentals Must Be Measured and Assessed Consistently

Across fixed income, we use consistent frameworks to assess valuation and credit fundamentals. This helps us stay disciplined and best manage the risks in our portfolios.

We apply our proprietary valuation framework to every investment. It provides a forward-looking estimate of return potential based on a security's yield, quality, liquidity, and call risk. We also build in a margin of safety[1] based on the long-term volatility of similar investments. Doing so allows us to evaluate our opportunities on a level playing field. Without adequate safety margin, we don't invest. We do not view volatility as risk, but rather as a generator of attractive entry points.

Regarding our fundamental analysis, we seek to identify issuers that have the ability and willingness to repay debts under a wide range of economic circumstances. We focus on a consistent set of criteria:

- Durability
- Defensive structure
- Transparency
- Effective management

We are committed to preserving our clients' capital, and the consistent application of these criteria across every investment is critical. Following the same approach also fosters a strong ethos of teamwork, from the junior to the most senior team members.

3. Credit Concerns or Poor Valuations Are Reasons to Wait for Better Opportunities

We believe that there are two risks to credit investments:

- Credit deterioration, such as elevated risks of near-term defaults or downgrades
- Entering credits at unattractive valuations

We will sell a credit if we see credit concerns, regardless of valuation. We will also sell a credit that no longer offers positive excess returns vs. risk-free assets.

Our research and experience show that it is better to wait for the next attractively priced, durable credit instead of holding onto a poorly valued one. This approach aligns strongly with clients' interests, as the intent is to reduce the portfolio's risk instead of "reaching for yield."

4. Construct Portfolios So Other Factors Have a Controlled Impact on Performance

As outlined, every investment we own is carefully researched and satisfies our valuation and credit criteria. A final step is assuring that the mix of exposures in portfolios does not create any unintended risks or concentrations that can overwhelm the performance benefits we expect to achieve.

This involves controlling the risk of interest rate movement vs. the strategy's objectives, ensuring proper diversification, modeling risk factors, and maintaining similar exposures across client portfolios so that client performance experience is aligned with expectations.

[1] *Margin of safety: A margin of safety exists when the additional yield offers, in BBH's view, compensation for the potential credit, liquidity, and inherent price volatility of that type of security, and it is therefore more likely to outperform an equivalent maturity Treasury instrument over a three- to five-year horizon.*

PUTTING IT TOGETHER

Our clients realize profound benefits from seemingly simple tenets:

- Valuations drive allocations, and our analysts and traders play critical roles in identifying and evaluating new opportunities.
- We employ a valuation framework that allows us to efficiently assess a broad range of opportunities across sectors.
- We pay careful attention to, scrutinize, and stress test each credit's resilience and ability to withstand the unexpected.
- Our portfolios reflect our team's best thinking, given guideline constraints, and may not resemble their benchmarks only in rate duration.

THE PATH AHEAD

We are all pleased that bonds are back and once again provide a combination of income, liquidity, and diversification. Over the past decade, our strategies have prevailed through a range of challenges: record low rates, a pandemic, and the most aggressive tightening in generations.

We believe our bottom-up active management approach will remain effective, independent of what happens with interest rates. Looking forward, we are excited about new opportunities emerging from the retreat in bank-originated lending.[2] This is creating persistent opportunities in asset-backed securities, corporate bonds and loans, and commercial mortgage-backed securities. As always, careful bottom-up evaluation is critical to our success. We expect valuation cycles driven by investor fear and greed will continue, and we stand ready to capitalize as we march forward.

CONCLUSION

We believe that the combination of these beliefs – and the manner in which we execute them – allow BBH fixed income portfolios to not just add value, but also provide stability to our clients' investment portfolio. These allow our clients to "sleep well at night" and focus their energies on their business and mission. ■

Past performance does not guarantee future results.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, maturity, call, and inflation risk; investments may be worth more or less than the original cost when redeemed. The value of some asset- backed securities and mortgage-backed securities are subject to prepayment and extension risks.

NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

[2] *Traditional ABS include prime auto-backed loans, credit cards, and student loans (FFELP). Nontraditional ABS include ABS backed by other collateral types.*

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