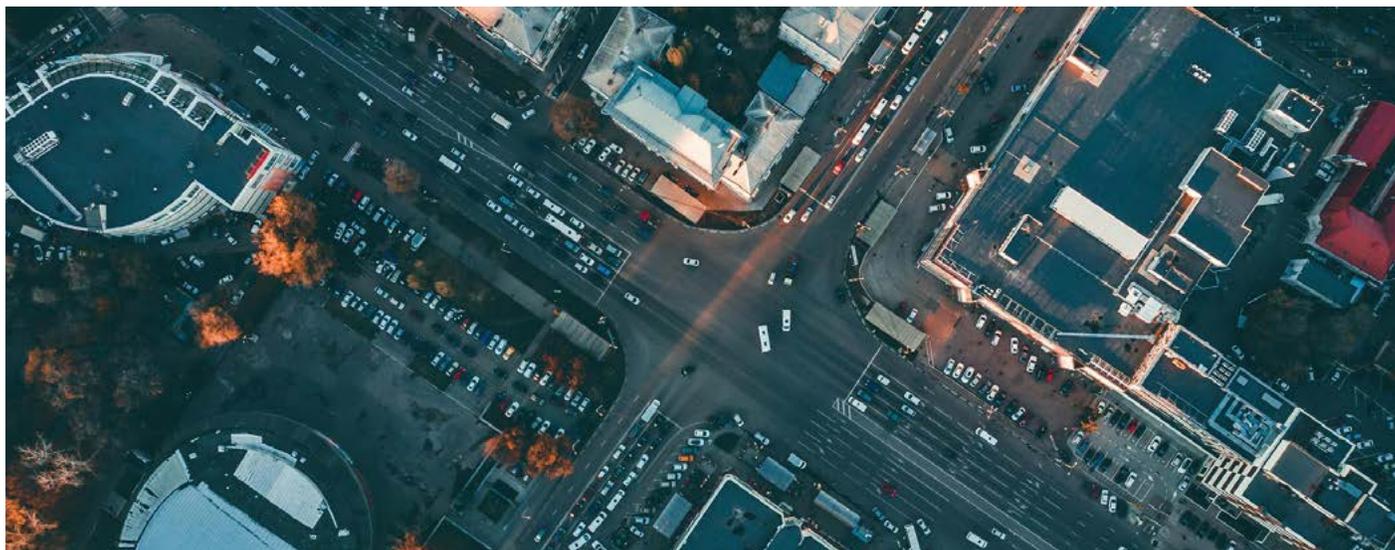


What should endowment investors be doing about inflation?



The future looks different



The re-emergence of inflation is all too obvious and continues to have an increasing impact on our daily lives. For investment markets, the specter of high inflation has triggered a repricing of expectations around the pace and extent of central bank tightening, bringing volatility and significant losses over the year to date. This has been exacerbated by the terrible events unfolding in Ukraine.

For many endowments, inflation is a double-edged sword. Not only does it precipitate a more treacherous market backdrop for investment portfolios to navigate, but it also makes achieving the inflation-relative targets that are so commonplace in the sector definitively more challenging. Furthermore, it comes at a time when many organizations face rising expenses through spiraling wages and higher borrowing costs, while also seeing greater demand for their resources amidst a cost-of-living crisis.

Since the global financial crisis, the market backdrop has — with hindsight — been highly supportive for investors; many endowments have enjoyed a period of stellar returns, outperforming their inflation-plus objectives in many cases. Going forward, we expect the market environment to be more challenging. Strategies that have worked in the deflationary conditions experienced over the last few decades are unlikely to be as effective over the next one.

Although many endowments will have genuinely long-term horizons and may be able to look through shorter-term noise to some degree, **we encourage organizations to review their strategic objectives in light of the evolving backdrop for inflation and to consider whether any changes should be made to their investment strategy and spending plans in the short to medium term.** Investors should also look to understand and enhance the level of inflation exposure within portfolios, working closely with their investment managers and advisors.

What's been happening to inflation?

Inflation has been rising sharply since the fall of 2020, as countries began to reopen economies on the back of vaccination rollouts. Boosted by excessive stimulus, this pent-up demand was met with supply-chain disruptions and shortages, culminating in inflation in many countries reaching multi-decade highs early in 2022.

While challenging for investors, we viewed this overheating as largely inevitable and somewhat transitory, with an easing of supply-chain pressures and a controlled tightening of monetary policy being necessary to guide inflation back toward, but modestly above, central bank targets over time.

This view was disrupted by Russia's invasion of Ukraine and the subsequent sanctions imposed on Russia by the West. For the time being, this pushes down our expectations for global growth and pushes back what we see as the peak for inflation and its subsequent descent. It goes without saying that the longer the hostilities continue and commodity prices remain elevated, the greater the likelihood of a prolonged period of high inflation or even stagflation, as we outline further in our recent article, ["Inflation — Turning Up the Heat."](#)



What should endowment investors consider?

This assessment may paint a troubling picture. However, we believe there are actions endowment investors can and should take at a strategic, portfolio and manager level to improve resilience.

1. Reconfirm investment strategy and spending objectives in light of higher inflation

Many endowments have a strategic objective to preserve the value of their assets in real terms over the long term, while generating an incremental return with which to meet their spending obligations. Typically, we see this take the form of an inflation-plus target, often between 2% and 5% per annum above the consumer price index, net of fees.

From where we are today, achieving an inflation-plus target will be extremely difficult over 2022 and will likely prove challenging over 2023 and potentially into 2024.

It is therefore important for organizations to review their strategic objectives and spending assumptions (where there is flexibility to do so) to ensure their continued suitability. Modeling how changes in spending may impact on the endowment over the medium to long term can be helpful to better inform spending programs and to ensure intergenerational equity has been considered. Moreover, organizations could consider setting parameters around which spending may be flexed up or down.

For many organizations, reducing spending at a time when funds may be needed most will not be palatable. As a result, we would also suggest more frequent monitoring of endowment progress versus assumptions, as well as placing emphasis on careful management of stakeholder expectations.

Looking further ahead, while we do expect inflation to return toward target levels, organizations should test their ability to support their current objectives in the event that inflation remains structurally higher over the longer term, taking action where needed.

2. Understand inflation exposures and consider how to improve resilience across a range of scenarios

At a portfolio level, we believe investors should review their inflation exposure. **To begin with, investors should seek to understand what inflation-sensitive assets already exist in the portfolio, over which time horizon these assets may provide exposure and how to diversify more efficiently.**

For investors without an allocation to real assets, this may be a logical starting point. Adding exposure to real estate and/or infrastructure through listed or unlisted approaches can provide a good degree of longer term inflation sensitivity along with a predictable income stream. Liquidity constraints need to be kept in mind when considering investment in private assets with longer lock-up periods.

Investors could further strengthen shorter term inflation linkage through strategies such as natural resource equities, active commodity strategies or even an allocation to gold, the latter due to its safe-haven characteristics and higher sensitivity to inflation when accelerating from already high levels. For investors who are more governance constrained, some multi-asset strategies can provide access to such opportunities as part of a broadly diversified approach.

It is important to note that some of these suggestions may be associated with higher emissions and therefore present a dilemma for investors looking to manage climate-transition risk and decarbonize portfolios over time. Given that this a key consideration for investors, it can be managed through the careful selection and tailoring of strategy in order to incorporate climate-related and other ESG ambitions.

Given the low or negative yields available, we have found that very few endowments have had meaningful allocations to inflation-linked government bonds over the last decade or so. This position could change should interest rates and real yields continue to rise. Investors should be prepared



to consider such assets as a way of adding more explicit inflation protection to portfolios.

As an overlay, we advocate the use of scenario analysis to provide investors with a richer view of how their portfolio may perform in different economic environments and how additive potential changes may be. In our [inflation protection paper](#), we set out a number of scenarios showing how economies and markets could behave under different growth and inflation conditions. From there, we explore how we expect different asset classes to perform across these different scenarios. The key takeaway is to position portfolios broadly via inflation-sensitive assets towards a range of inflationary scenarios so that portfolio robustness is improved.

3. Engage with your investment managers and advisors to understand the actions they are taking on your behalf

Informed oversight of your investment arrangements becomes even more critical in an environment like that seen so far this year. Investors should engage with and challenge their investment managers on how they are positioning portfolios in the face of high inflation: for example, what changes can be made to improve resilience? How are they identifying the winners/losers at a company level? What are their views on the portfolio's ability to deliver against its stated objectives over different time periods?

Investors should have confidence that their providers are able to navigate this landscape and be willing to look through periods of shorter-term underperformance.

Without question, the year to date has been an extremely testing period for investment markets and for many investment managers. In particular, those strategies which have made progress against sustainability and/or decarbonization objectives have generally not participated in the energy-related rally which has offset some of the negative returns from other sectors. Not only does this pattern of performance make measurement versus inflation-plus targets obsolete (at least in the short term), it also reduces the comparability of broad market benchmarks which mask some of these nuances. Benchmarking against indices that better reflect the investment style or sustainability characteristics of a particular strategy can help with performance interpretation, while comparisons versus peers can be a useful way of further contextualizing performance when viewed on a risk-adjusted basis.

Finally, going forward, we expect a more challenging investment landscape to necessitate more frequent and effective engagement with investment managers and advisors. Some investors will be well equipped for this. For others, and particularly where investment responsibilities sit with the main trustee board, now may be an appropriate time to consider enhancing expertise via an investment sub-committee or even delegating oversight to a third party.

Contact us



We welcome feedback and dialogue about our observations on the future of investing for endowments and foundations in 2022. Please reach out to your Mercer consultant, or email us at mercerinvestmentsolutions@mercer.com

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