Investor Trends Report: Foundations & Endowments

eVestment Traditional Research
May 2014

Investor Trends Report: Foundations & Endowments

Introduction

The investor summary report uses eVestment's suite of intelligence to provide an overview of the recent allocation preferences of a particular investor. eVestment's recent survey of Foundations & Endowments (F&E) showed that "Incorporating managers with the experience to weather a low-yield environment" was one of their top investment challenges in 2014. This report will look at the allocation decisions over the twelve-month span ending Q1 2014 by F&E to illustrate to which universes they are reaching to deal with these challenges and what particular characteristics they favor within these universes.

Asset Allocations & Universe Flows:

F&E allocations are currently weighted heavily towards US markets focused on equity and fixed income. Within US markets, F&E largest allocations are to Large Cap Value, Core Fixed Income, Large Cap Growth, Interim Duration FI and Core Plus FI. Outside the US, F&E have allocated heavily to Emerging Markets and Global All Cap Equity universes.

F&E flows, however, tell a different story about their current sentiment for their largest positions and also reflect their concerns stated in eVestment's survey. Over the last four quarters, F&E have been actively removing assets from all of their top holdings (*figure 2, left*).

In place of active US equity, global equity strategies appear to be preferred, with a preference for passive strategies. Fixed income preferences shift from US-focused core and short and interim duration strategies to global bonds, or within the US, floating rates, longer durations and high yield.

In summary, to face a low-yield environment with an uncertain outlook, F&E appear to be actively shifting portfolios to cost-effective global equity exposure and seeking higher yields and longer duration fixed income.

Figure 1: Breakdown of F&E exposures across major universe segments as of Q4 2013 (left) and Relative Weights of Top Universes (right)

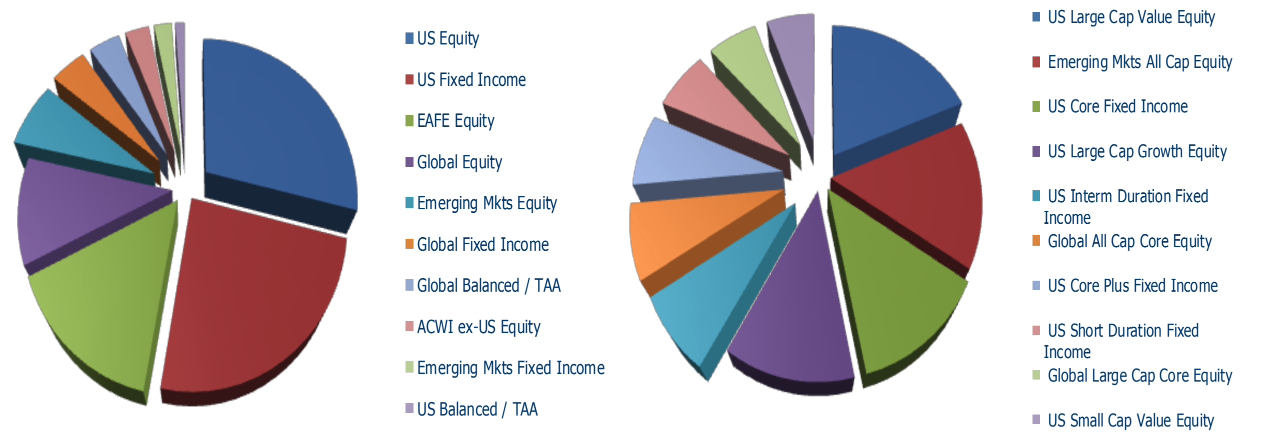
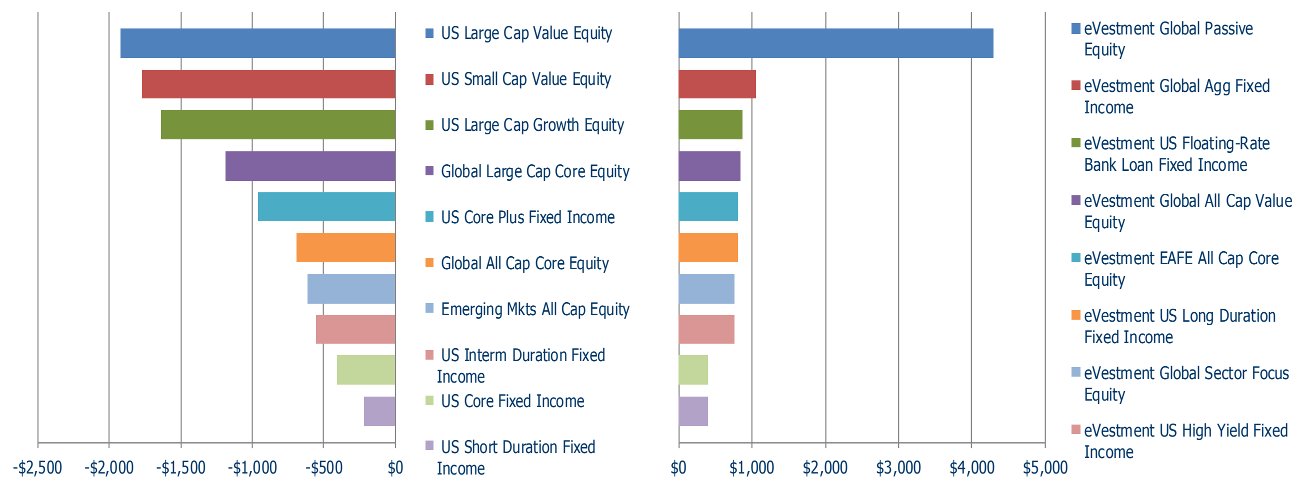


Figure 2: Breakdown of F&E asset flows over the last twelve months ending Q1 2014 for their largest universe holdings at the end of 2013 (left) and their largest universe allocations (right), USD millions



Investor Report: Foundations & Endowments

Exposure Preferences - Global Aggregate Fixed Income

Outside of passive global equity exposure, F&E allocated the most assets to strategies in the Global Aggregate Fixed Income (GAFI) universe. By isolating the strategies within that universe, and looking at the characteristics of their portfolios and how they have changed over time, we can isolate the specific attributes most desired by F&E.

Characteristics:

In changing from low and interim duration US fixed income exposure, F&E have allocated to funds which have been increasing their cash positions, reducing their yield to maturity, but also increasing weighted average coupon, portfolio maturity and duration, the latter two having been in a more volatile path.

Figure 3: Average fixed income portfolio characteristics of Global Agg Fixed Income strategies gaining F&E assets in the last four quarters ending Q1 2014

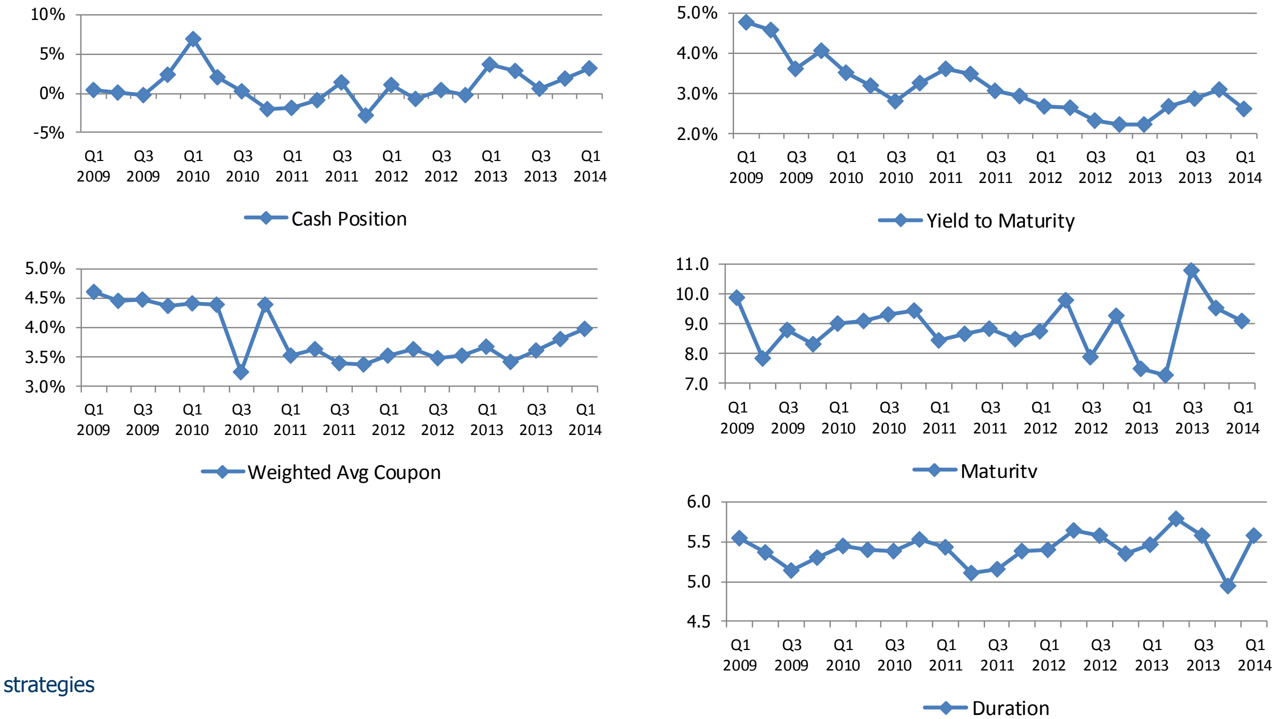
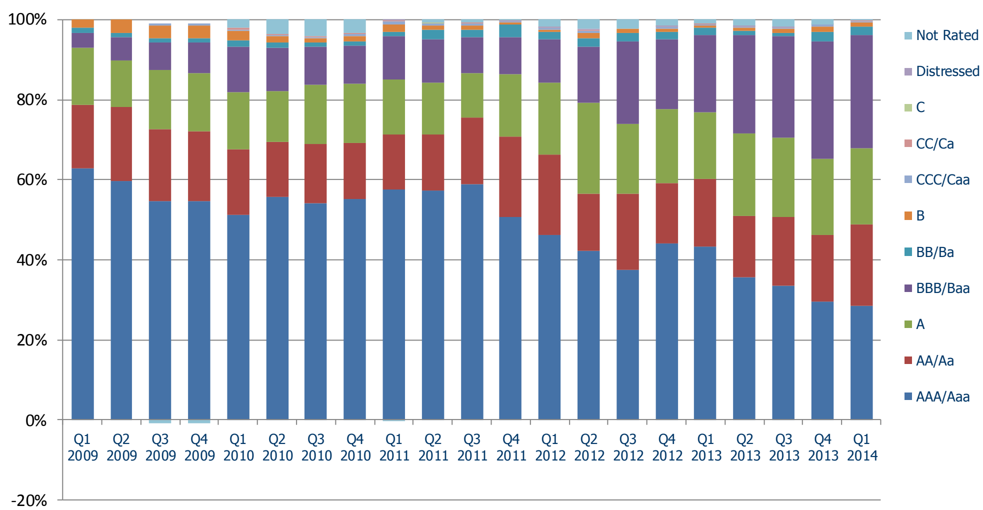


Figure 4: Change in average portfolio quality of Global Agg Fixed Income strategies gaining F&E assets in the last four quarters ending Q1 2014



Credit Quality:

F&E appear to be favoring GAFI strategies that have either through active management, or through the deterioration of holdings, shifted their portfolios away from AAA down to BBB, nearly bypassing AA while increasing exposure to A-rated credits. When the characteristics information is combined with credit quality exposure data, the preferences of F&E are more clear. In order to maintain a certain level of yield, they have been forced to move out on the credit spectrum. This is generally true for any non-alternative strategies that have operated with specific return expectations.

The following page will show the sector exposure for those GAFI strategies gaining F&E assets in the last 4 quarters.

Investor Report: Foundations & Endowments

Sector & Regional Exposures:

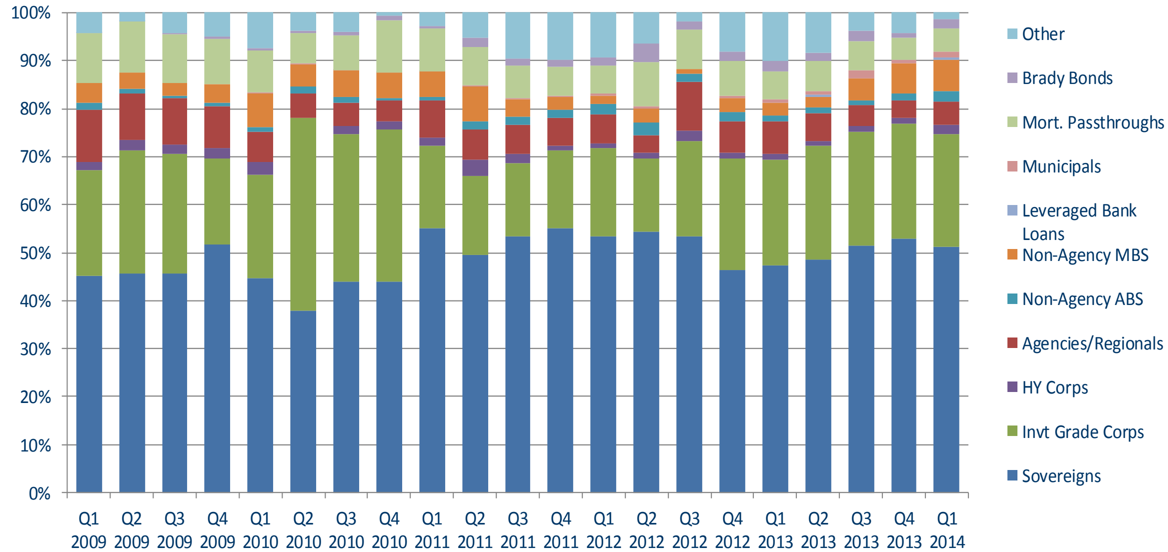
With the understanding that F&E have been allocating to strategies which have been reducing the credit quality of portfolio holdings from AAA into BBB, and to a lesser extent A-rated holdings, understanding the types of securities and regions providing these exposures is important.

F&E have allocated to strategies whose exposure to sovereigns is actually higher than their 5-year average and at the same time these strategies appeared to have increase exposure to inv. grade corporates at the start of 2013, since maintaining that level. Additionally, F&E have been allocating to strategies increasing exposure to non-agency MBS markets.

From a regional perspective, we see slightly reduced exposure to North America, no meaningful change to Europe, but a noticeable increase to emerging markets beginning in 2013. Additionally, while sovereign exposure has remained relatively stable, there is a noticeable shift away from US sovereign debt to non-US developed market sovereigns.

F&E, in their attempt to increase duration and move away from US fixed income, have been allocating to strategies that are still primarily invested in sovereign debt, but increasingly in developed markets outside the US and emerging markets, while exposure within the US is increasingly in the form of non-Agency MBS securities.

Figure 5: Change in average portfolio sector exposure (top) and regional exposure (bottom) of GIFA strategies gaining F&E assets in the last four quarters ending Q1 2014



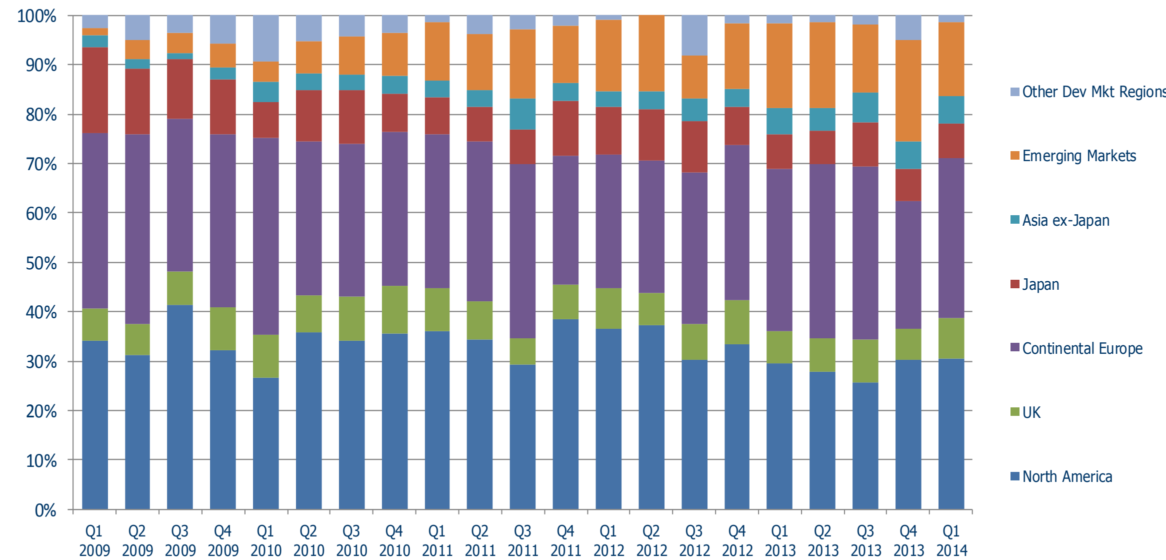
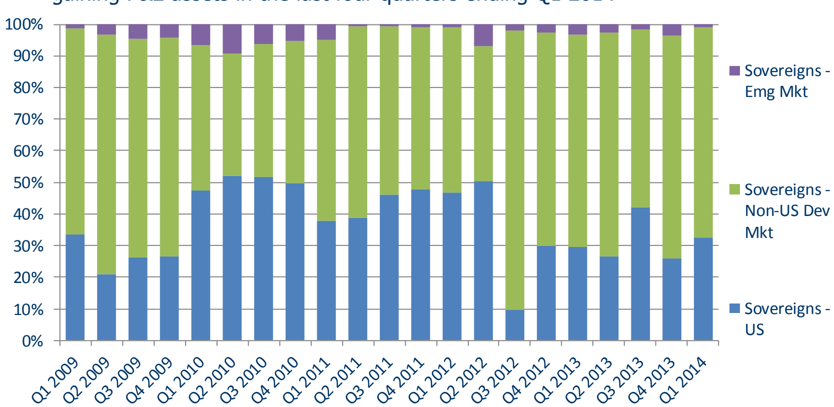


Figure 6: Change in average portfolio sovereign exposure of GIFA strategies gaining F&E assets in the last four quarters ending Q1 2014



Investor Report: Foundations & Endowments

Hedge Funds:

There are numerous surveys of F&E which indicate an increased interest in allocations to hedge funds, but also across the universe of alternatives, including private equity, real estate and real asset investments. The indication being that F&E appear willing to accept lower levels of liquidity, at least via alts investments, to reduce market risk and increase yield or return.

eVestment's hedge fund data does not track asset levels and flows by investor type, however looking at flows by asset class and strategy within the hedge fund space in 2013 and Q1 2014, we see evidence of the same types of preferences F&E show in their recent allocations to traditional strategies.

Allocations to the hedge fund industry have accelerated over the last three quarters. Throughout 2013 there were large inflows to credit and multi-strategy funds and entering 2014 investors have heavily increased allocations to long/short equity and event driven strategies, all which appear to be at the expense of managed futures and macro strategies.

Relating this data to F&E preferences, we recall that F&E have been reducing their exposure to traditional active US equity and US fixed income strategies. With that in mind, it would make sense to see F&E move to alternative equity strategies for active management to complement their allocations to passive global equity exposures. Similarly, the move away from US-focused short and mid duration strategies to address the current relatively low rate environment with an uncertain future, would relate well to the massive flow of assets seen into alternative credit strategies throughout 2013 and into 2014.

Figure 5: Total hedge fund industry assets (left axis, blue) and net investor flows (right axis, red) for Q4 2003-Q1 2014, USD billion

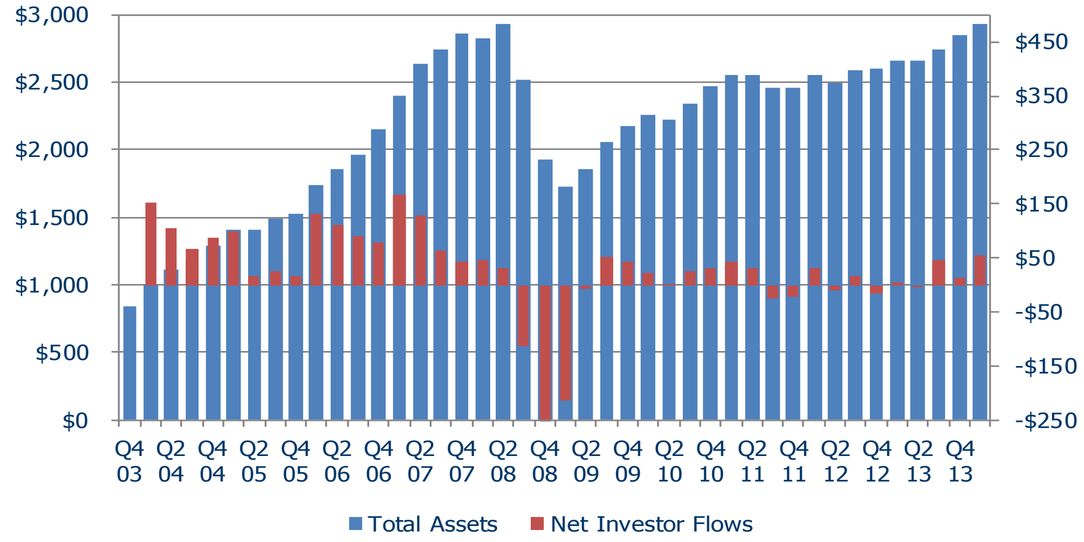
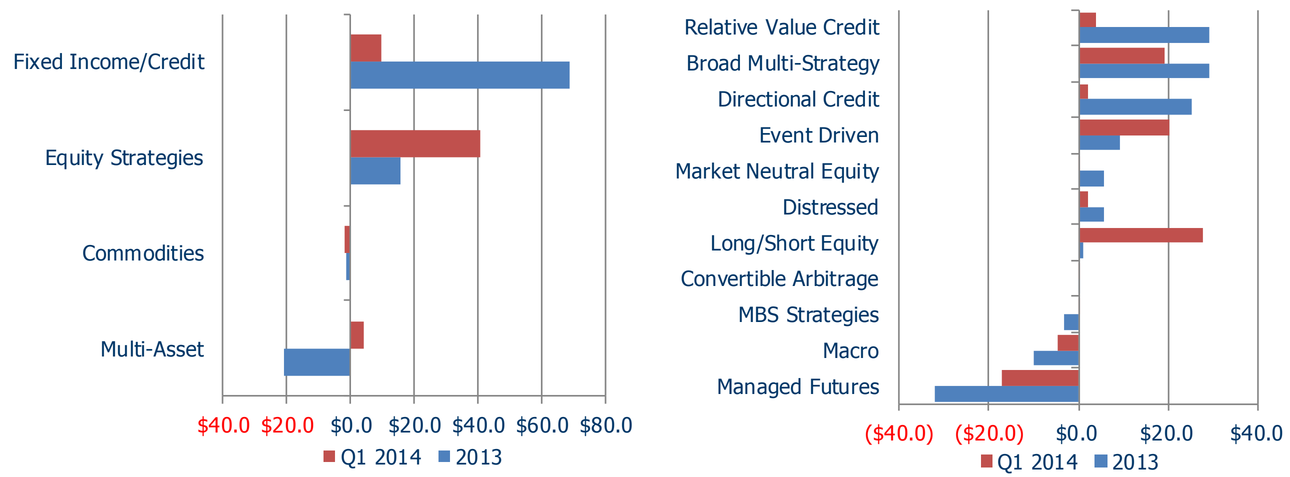


Figure 6: Total estimated flows for hedge funds by asset class of focus (left) and primary strategy (right) for 2013 and Q1 2014



Investor Report: Foundations & Endowments

Summary:

Foundations & endowments typically have a dual purposes for their funds, to maintain and grow the portfolio after expenses and spending, and to generate reasonably predictable cash flows for their varying operating budgets and goals. With this backdrop, it is clear why the current interest rate environment, along with a strong 5-year run in US equity markets has caused concern.

In response, F&E appear to be actively transitioning portfolios away from their largest holdings. To mitigate the risks of a US equity market decline, large allocations have gone to international markets, but doing so through passive strategies. Additionally, recent large inflows into long/short and event-driven hedge funds likely include allocations from F&E. This would further reduce their directional risks and create more flexible regional exposures.

F&E have been actively addressing their concerns over the levels and future direction of interest rates by shifting to traditional global fixed income, and within the US to floating rate bank loans, high-yield and long duration strategies. With multiple surveys illustrating interest in hedge funds, private equity and real assets, along with what have been large aggregate flows into alternative credit strategies, F&E have been active in searching for new sources of yield and return from credit markets while also attempting to reduce exposure to directional movements in rate markets.

COMPANY DESCRIPTION

eVestment provides a flexible suite of easy-to-use, cloud-based solutions to help the institutional investing community identify and capitalize on global investment trends, better select and monitor investment managers and more successfully enable asset managers to market their funds worldwide.

With the largest, most comprehensive global database of traditional and alternative strategies, delivered through leading-edge technology and backed by fantastic client service, eVestment helps its clients be more strategic, efficient and informed. PerTrac and Fundspire became part of eVestment in 2012.

For more industry research visit:
www.evestment.com/resources/research-reports

For more on eVestment's research platform visit:
www.evestment.com/products/research

eVestment - LOCATIONS

Atlanta
5000 Olde Towne Parkway
Suite 100
Marietta, Georgia 30068
United States
+1 (877) 769 2388
www.evestment.com
support@evestment.com

London
Candlewick House
120 Cannon Street
London, England EC4N 6AS
United Kingdom
+44 (0) 20 7651 0800
europe@evestment.com

New York
58 W 40th Street
4th Floor
New York, New York 10018
United States
+1 (212) 661 6050
support@evestment.com

Hong Kong
Level 18
Wheelock House
20 Pedder Street
Central, Hong Kong
+852 2293 2390
asia@evestment.com

Reno
6170 Mae Anne Avenue
Suite 3
Reno, Nevada 89523
+1 (877) 769 2388
support@evestment.com

Sydney
Level 26
1 Bligh Street
Sydney NSW 2000
Australia
+61 (0) 2 8211 2717
australia@evestment.com

eVestment – RESEARCH DIVISION

Peter Laurelli, CFA
Vice President
plaurelli@evestment.com
+1 (212) 230 2216

Minkyu Michael Cho
Analyst
mcho@evestment.com
+1 (212) 230 2209

Tony Kristić
Analyst
tkristic@evestment.com
+1 (646) 747 6177

Media Contact

Mark Scott
Global Public Relations
(678) 238 0761 office
(404) 450 8265 cell
mscott@evestment.com