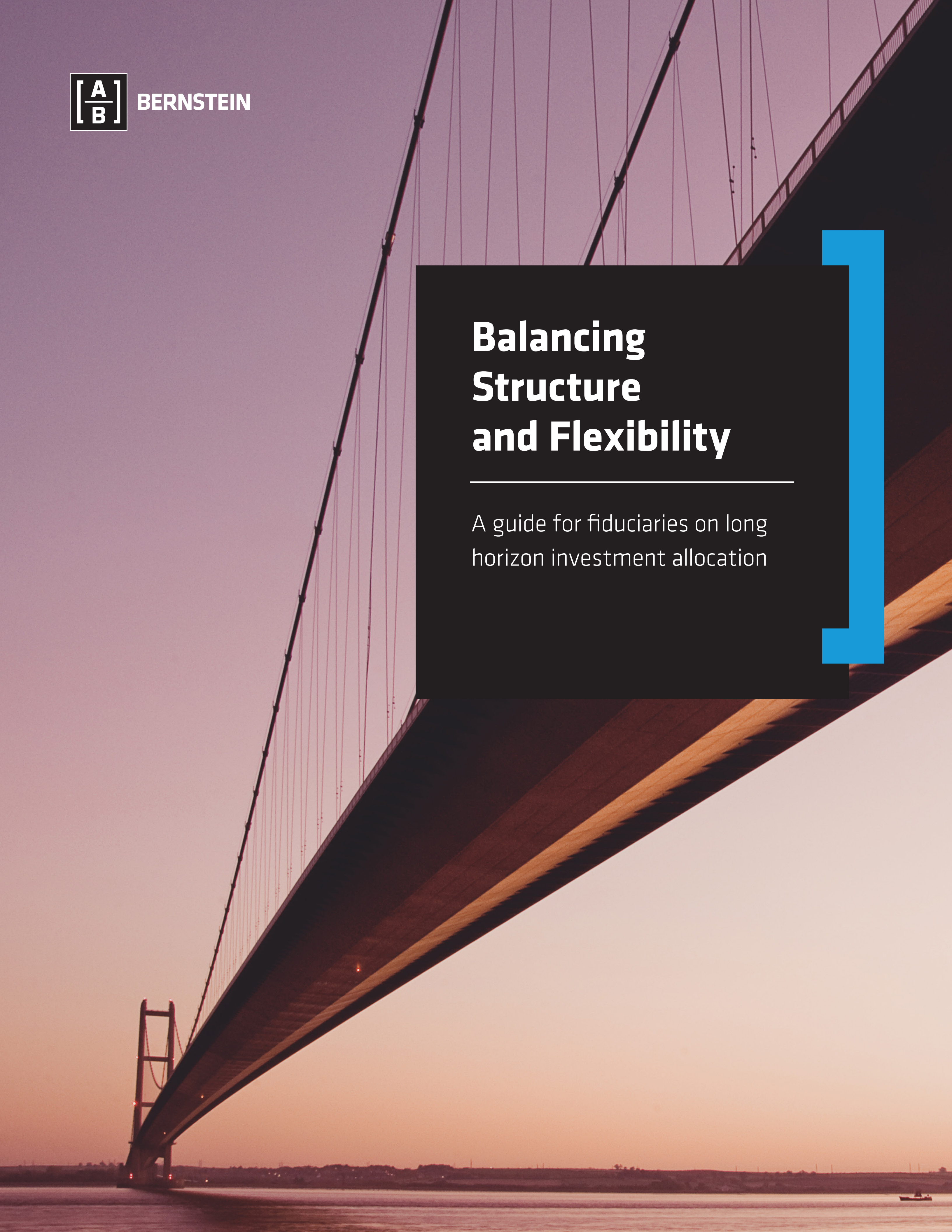
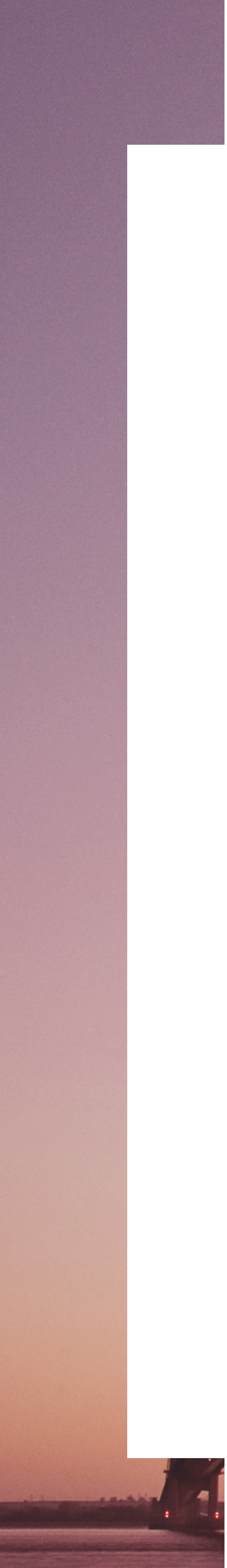


BERNSTEIN

Balancing Structure and Flexibility

A guide for fiduciaries on long horizon investment allocation



Uncertain Times Ahead

Investors enjoyed a long stretch of robust returns from when the global financial crisis roiled the markets over 15 years ago through the end of 2021. Up over 12% annually since 2009, global equity markets advanced at nearly twice the pace of the decade before, during a period that began with the worst financial crisis in the U.S. since the great depression and ended with the onset of the global COVID pandemic.[1] At the same time, falling interest rates kept total bond returns solidly in positive territory. Then came 2022.

Fallout from supply chain disruption, pandemic lockdowns and government efforts to stave off a potentially catastrophic recession stoked a resurgence in inflation not seen in decades. Central banks around the globe responded with aggressive monetary tightening, including the Federal Reserve, which raised policy rates to their highest level at the fastest pace in modern times. Markets swooned. Global stocks fell over 18% while taxable intermediate U.S. bonds had their worst calendar year on record, declining 13%.[2]

The good news is that inflation has slowed somewhat, and the Federal Reserve and other central banks appear to be near (if not at) the end of this tightening cycle. That has helped markets recover some lost ground. Yet the problem remains that the long era of low inflation and interest rates is probably behind us. We project lower equity and bond returns over the next decade than what we've experienced the last several years. Even if we experience equity and bond returns in line with long-term averages—when paired with higher interest rates, potentially elevated inflation, and increasing market volatility—nonprofit organizations will find it difficult to sustain distributions and maintain, let alone grow, portfolio assets.

Luckily, these tectonic shifts are not immediate, nor will they all occur simultaneously. Fiduciaries have an opportunity to set a sound and thoughtful investment policy to help support their institution's mission. This begins with determining how much the organization should be holding in cash and more conservative investments for the near term, so that all excess funds—both restricted and unrestricted—can be invested appropriately for long term growth. In response, Bernstein has built a proprietary tool designed to answer key questions:

- How much true cash do we really need?
- Should we reserve more or less than other organizations?
- How should we invest both short- and intermediate-term reserves?

> Fiduciaries are facing a big challenge today. Confronted with inflationary pressures, market volatility, and an ever-broadening array of investment choices, board and executive leaders face a formidable task—developing an investment strategy that is structured for today's investment environment while remaining focused on their long-term mission.

1 MSCI World Index—return from Jan 2009 through Dec 2021 was 12.33%; from July 1998 through June 2007, 5.99%.
2 MSCI World Index—return for calendar year 2022 was –18.14%; Bloomberg US Aggregate Index was –13%.

In some cases, that may mean assuming modestly more risk with certain pools of assets in order to pursue more reward. After all, the spectrum of short- to intermediate-term reserves includes different time horizons and liquidity needs compared to cash on hand or designated long-term funds. Bernstein's cash reserves analysis framework can help fiduciaries decide how much risk is prudent for a variety of pools of assets with distinct purposes and needs.

Once we know what we can actually invest for the long term, we can then establish an optimal strategic allocation that meets long-term goals for return and risk.

How Sustainable Are Your Distributions?

No matter how conservative or aggressive a portfolio was positioned over the past 30 years, its returns probably exceeded the historically low inflation rate of 2.2%.

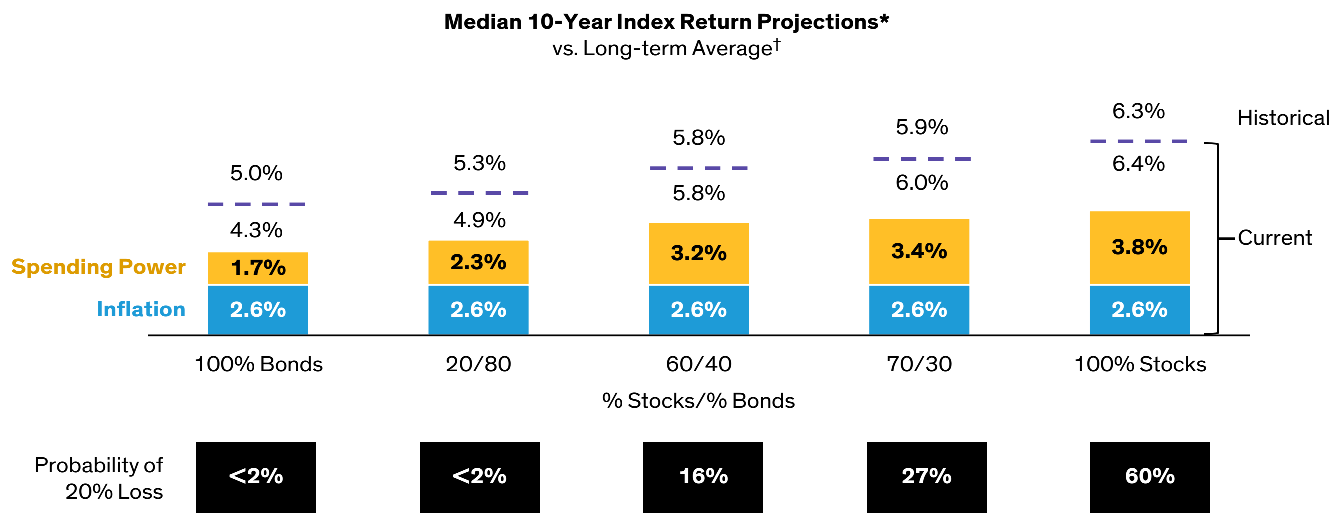
Going forward, however, fiduciaries must consider the possibility of higher inflation. We project that over the next 30 years, a portfolio with a traditional balanced allocation of 60% in stocks and 40% in bonds will have just 3.2% for withdrawals after inflation, falling short of the average endowment distribution rate of 4% and even further away from the required 5% rate for private foundations (*Display 1*).[3] Going to a full allocation to stocks only increases the withdrawal rate to 3.8%, still shy of the roughly 5% required distribution rate for private foundations, while also increasing risk, with a 60% chance of a loss at least once of 20% over the next 30 years.

Organizations that were once able to adopt a traditional approach may need to reassess their investment policies to achieve their targeted after-expense, after-inflation return. This starts with designing an appropriate strategic asset allocation policy.

Driving Long-Term Performance

A strategic allocation policy must establish the total return necessary to satisfy withdrawals or distributions (investment objective), determine the expected life of the fund (time horizon), and understand the ability to weather a sustained drawdown (risk tolerance). Considering all these factors when establishing an allocation policy may be overwhelming, but an investment advisor that has experience designing and implementing nonprofit investment policies can provide invaluable advice and guidance.

DISPLAY 1: WE EXPECT LOWER FUTURE RETURNS PUTTING POTENTIAL PRESSURE ON SUSTAINABLE DISTRIBUTIONS



As of June 30, 2023

*Represents projected pretax compound annual growth rates. Stocks modeled as MSCI World Index. Bonds modeled as intermediate-term taxable bonds.

†"Long-term Average" returns are rolling average 5-year compound annual growth rates over the past 30 years. Example, average rolling 5-year core CPI in the US was 2.2% as of December 31, 2023.

Based on AB's estimates of the range of returns for the applicable capital markets over the periods analyzed. **Data do not represent past performance and are not a promise or arange of future results.** See Notes on Wealth Forecasting System at the end of this document.

Source: Barclays, MSCI, S&P, and AB

3 Refers to private, non-operating foundations throughout this paper

The strategic allocation policy sets a long-range plan, but it should also account for possible market conditions, like the chance of lower returns or higher inflation in the future. Organizations have three choices to address a change to return expectations that may impact distributions: obtain revenue from other sources, change withdrawals, or shift asset allocation. Assessing opportunities to source revenues is outside the scope of this paper, so we will focus first on the distribution policy, and second on asset allocation. The first step is understanding the objective.

Spend Less Now to Spend More Later

The investment objective for many organizations is to maintain the principal value of their portfolio after inflation while meeting a 3%–5% annual distribution rate in perpetuity. Unfortunately, even when faced with a shortfall, reducing withdrawals for many organizations is often not possible. In fact, many nonprofits would often like to spend more, but 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 nonprofit would only have a 13% chance of maintaining purchasing power of the portfolio over the next 30 years.[4] If it decided to decrease withdrawals, say by 1%, from 5% to 4%, the likelihood of maintaining purchasing power over 30 years would more than double to 28%.

Withdrawing less today means more is available for the future (*Display 2*). The 4% withdrawal rate represents lower annual distributions initially, but gradually the gap between this rate and 5% annual distributions closes. At year 10, the difference is just 13%, and by year 20, it falls to only 4%. Once the crossover point is reached, the 4% policy will distribute more annually and still leave the endowment with higher remaining assets.

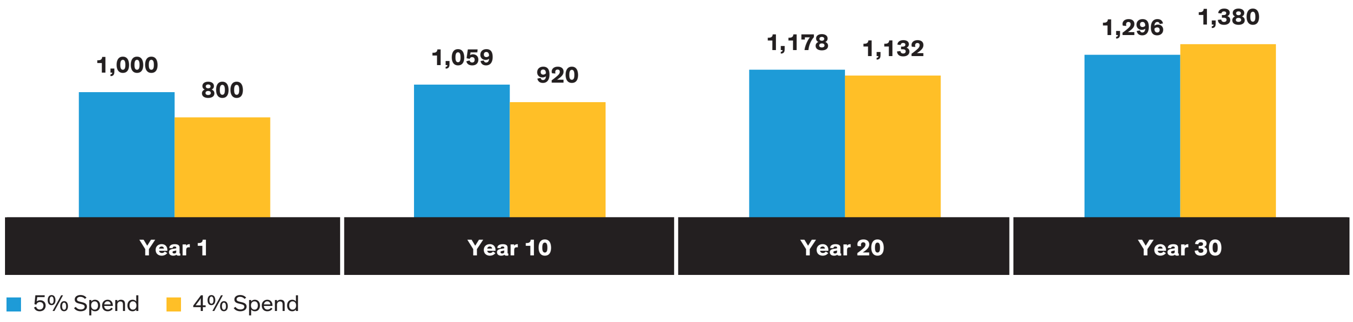
If the intention is to last into perpetuity, fiduciaries need to consider ways to increase returns to meet withdrawal needs.

Changing The Mix

A common way to boost returns is to increase the allocation to return-seeking assets like stocks. Stocks tend to perform well over the long term and offer a better hedge against rising inflation but can be quite volatile over shorter time periods. High-quality intermediate bonds, which tend to have a low correlation to stocks, are normally used to offset this equity volatility. Bond returns are far more predictable, but are historically lower than stocks.

DISPLAY 2: ANNUAL DISTRIBUTIONS SPENDING

USD Millions, Nominal, 60% Stock/40% Bonds (Thousands)



As of June 30, 2023.

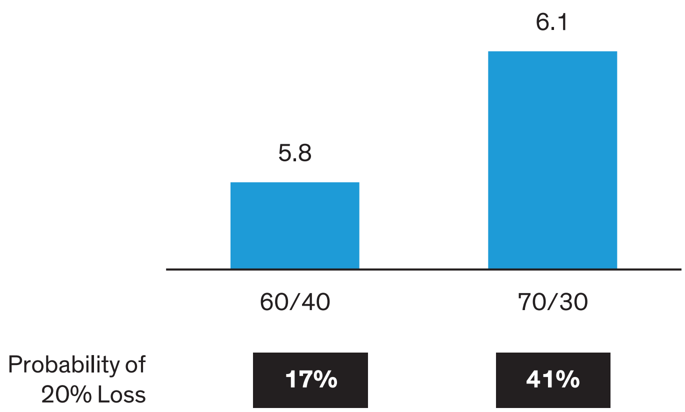
Initial assets of $20 million with a 3-year smoothing spending policy.

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 Wealth Forecasting System at the end of this document.

4 Based on the WFS: Assumes initial assets of $20 million and 3-year smoothing. Maintaining purchasing power is the probability of having $20 million in 30 years in real dollars. Assumes an asset allocation of 60% Global Stocks/40% Intermediate Taxable Fixed Income.

DISPLAY 3: INCREASING EQUITY EQUALS HIGHER RETURNS AND RISK

Expected Returns*



As of June 30, 2023

*Projected pretax 10-year compound annual growth rate of median index returns. Data indicate the probability of a peak-to-trough decline of at least 20% over the next 10 years. Because the Bernstein Wealth Forecasting System uses annual capital-markets returns, the probability of peak-to-trough losses measured on a more frequent basis (such as daily or monthly) may be understated. The probabilities depicted above include an upward adjustment intended to account for the incidence of peak-to-trough losses that do not last an exact number of years. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the periods analyzed. **Data do not represent past performance and are not a promise of actual future results or a range of future results.** See Notes on Wealth Forecasting System at the end of this document.

Source: Barclays, MSCI, S&P, and AB

The decision to increase exposure to stocks or bonds is therefore the classic risk-return trade-off dilemma. When the percentage of stocks in a portfolio increases, say from 60% to 80%, returns improve by 30 basis points or 0.3%, but the probability of a 20% peak-to-trough loss also moves higher, from 17% to 41% (*Display 3*). Meanwhile, the expected return from bonds is more attractive today versus recent years (courtesy of higher rates), so now investors can weigh the tradeoff with one side of the equation having markedly improved (*Display 4*). We think fiduciaries can take comfort that their allocation to fixed income should pull more of its weight in the portfolio than in years past.

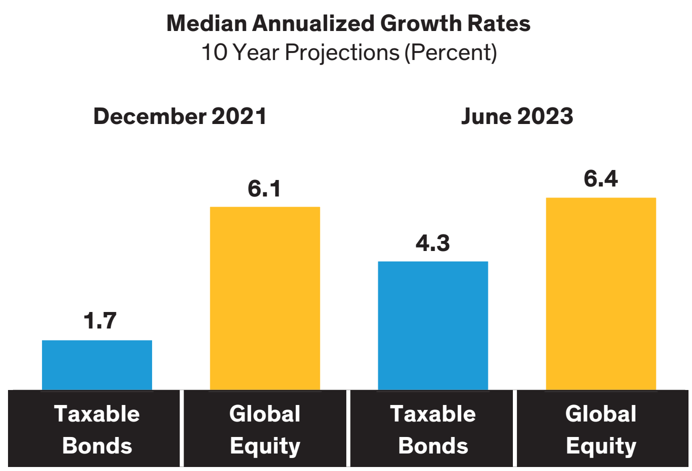
Going Beyond Stocks and Bonds

While expected bond returns have brightened the picture for traditional allocations, the likelihood of higher inflation going forward means investment committees still have their work cut out for them to meet desired spending and risk/return goals. Diversifying strategies, which tend to have a low correlation to both stocks and bonds, can help fill in the gaps. These strategies, often referred to as alternatives, include securities related to "real" or nonfinancial assets, such as real estate and commodities, as well as less liquid assets, such as hedge funds, private equity, and private credit.

While alternatives can add a layer of complexity, and fees tend to be higher than for traditional investments, the benefits can be substantial. For example, private equity returns over the past 20 years handily exceeded those of stocks by over 500 basis points and during a period when stocks experienced double-digit performance.[5] Diversification is another benefit: the pattern of returns tends to differ

DISPLAY 4: EQUITIES LESS ATTRACTIVE RELATIVE TO BONDS

With Increased Interest Rates, the Expected Equity Risk Premium Decreased



As of June 30, 2023

Past performance does not guarantee future results.

Stocks modeled as MSCI World Index. Bonds modeled as intermediate-term taxable bonds. **Data do not represent past performance and are not a promise of actual results or range of future results.** Based on Bernstein's estimates of the range of returns for the applicable capital markets over the periods analyzed.

Source: Barclays, MSCI, S&P, and AB

5 Private equity is represented by the Cambridge Associates LLC US Private Equity Index which annualized at 15.25% for 20-years ending June 30, 2023. The index is a horizon calculation based on data compiled from 1,529 US private equity funds, including fully liquidated partnerships, formed between 1986 and 2023. Data is a pooled horizon return, net of fees, expenses, and carried interest. Public equities are represented by the Russell 3000 using a CA Modified Public Market Equivalent (mPME) which replicates private investment performance under public market conditions and which annualized at 10.11% for 20-years ending June 30, 2023 . The public index's shares are purchased and sold according to the private fund cash flow schedule, with distributions calculated in the same proportion as the private fund, and mPME NAV is a function of mPME cash flows and public index returns Sources: Cambridge Associates LLC, Frank Russell Company, MSCI Inc. and Thomson ReutersDatastream.

from that of public equities, actively offsetting their performance. Further, while the number of publicly traded stocks is shrinking, a trend that started in the last few years, the number of private companies is growing, offering a greater pool of candidates from which to choose. For a fund looking to achieve higher returns than bonds without the additional risk introduced by increasing public equities, alternatives could be the answer.

Adding To Illiquid Exposure Can Improve Outcomes

But achieving higher returns using diversifying assets can also mean accepting more illiquidity, which we define here as a constraint on how quickly assets can be sold and converted to cash. Illiquid strategies often provide stronger returns, dampen volatility, and provide a source of returns that has a low correlation to the other liquid portions of the portfolio. And investors often get paid for holding these less liquid assets: the illiquidity premium, or the excess return from owning these assets, varies greatly, but can add several percentage points of annual return.

We wanted to quantify what investors could plausibly expect from adding just 20% to a diversified mix of less liquid alternative assets using a 70% equity/30% fixed income risk profile over the next 10 years (*Display 5*). Incorporating our assumptions for future asset class returns and risk, the result was an improvement in median return of 60 basis points with an even larger reduction in annualized volatility at 1.5%.

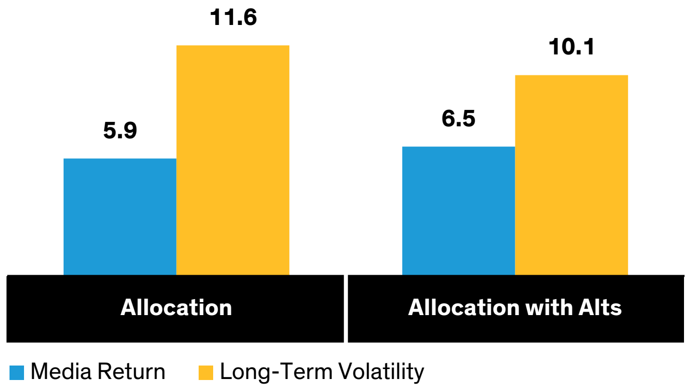
This is just one analysis, but it illustrates why larger endowments and foundations have been using illiquid investments in their allocations for many years. In fact, in a 2022 study of private and community foundations[6], private foundations with assets over $500 million allocated an average of 42% (22% for community foundations) to illiquid alternatives, including private equity, venture capital, and real assets like private real estate, while those below $101 million allocated considerably less at 15% (9% for community foundations).

6 Council on Foundations/Commonfund Study of Foundations 2022

Why this gap? Historically, larger organizations have access to more desirable managers and a greater array of investment products. But today, there are many more options that are accessible to "qualified purchaser" institutions with portfolios of $25 million or more, as well as "accredited investor" institutions with $5 million and up.

DISPLAY 5: RANGE OF PROJECTED RETURNS

10 Year Compounded Annualized Growth Rate



As of June 30, 2023. **The projections or other information generated by AIA regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results.** Results may vary with each use and over time. Actual future results may not meet AB'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. The information provided here is not intended for public use or distribution beyond our private meeting. Of course, no investment strategy or allocation can eliminate risk or guarantee returns.

We believe the gap is explained by the fear of a liquidity squeeze, or the inability to access enough funds when needed, and the increased due diligence required to invest in these more complex, illiquid investments.

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 illiquids, the remaining 85% of the portfolio is still available to meet liquidity needs. By working with an investment advisor who can help assess investment strategies, risk/return characteristics, liquidity, and fees for illiquid investments, committees can ensure that they are acting prudently and performing the appropriate due diligence (*Display 6*).

Active, Passive, or both?

When it comes to traditional stock and bond allocations, many fiduciaries wrestle with the choice between active and passive strategies. However, it does not have to be an either/or decision.

Given the strong performance of passive strategies in recent years, many committees have questioned whether high-cost, actively managed portfolios should be replaced with low-cost, passive strategies. But the environment over the last several years was one in which it was very difficult for active managers to produce excess returns, after fees. Today there are signs that the investment landscape is transitioning to an environment where active investing may add more value than it has in recent years (*Display 7*).

The benefits of passive and active strategies are less clear cut for bonds. Passive bond strategies often lack the flexibility to balance interest rate and credit risk. The benchmark that a passive strategy seeks to replicate will be weighted to frequent issuers of debt, and to bond durations that are most popular at that stage of the cycle. Active managers, on the other hand, are better able to reduce those risks by shifting to sectors that are at a different stage of the credit cycle or by adjusting duration. That said, the volatility in interest rates the last few years have challenged these conventional wisdoms and surveys show that investment committees are starting to embrace passive for fixed income.

DISPLAY 7: WHAT ENVIRONMENT IS LIKELY TO COME NEXT?

Conducive to Active	Conducive to Passive
• Higher Interest Rates	• Lower Interest Rates
• Average to Below-Average Equity Returns	• Above-Average Equity Returns
• Higher Volatility	• Lower Volatility
• Higher Dispersion, Lower Correlation	• Lower Dispersion, Higher Correlation
• More Passive Investors	• More Active Investors

Source: AB

DISPLAY 6: MATERIAL CONSIDERATIONS FOR INVESTMENT COMMITTEES

Risks Specific to Alternatives

Liquidity Shortfall Risk

- In accounts with illiquid investments, regular spending can cause significant drift from original allocation over time, since spending typically is sourced from liquid portfolios while illiquid portfolios remain untouched
- Illiquid alternative asset allocation should account for Liquidity Shortfall risk to ensure account will always have sufficient liquidity to support spending

Allocation Drift Risk (ADR)

- Illiquid investments tend to experience different return patterns than traditional investments
- Accounts with especially strong or weak illiquid alternative investment performance may experience dramatic swings in their exposure to illiquid investments without the opportunity to rebalance

Timing of Reporting/Valuation

- Potential delays in performance reporting up to a quarter or more
- Additional information needed by audit team for valuation of non publicly traded assets
- Filing of K-1s for certain investments

Source: AB

Regardless of the current investment environment, the choice between active or passive (stocks or bonds!) does not have to be an either/or decision. Some organizations are employing a hybrid approach by utilizing passive index products to get exposure to the more efficient segments of the markets where it's difficult to gain a competitive advantage through research at a low cost while using actively managed strategies as satellites to generate "alpha" (excess return) or manage risks. This allows organizations to focus their fee budget on strategies that deliver idiosyncratic returns.

Navigating Periods of Heightened Uncertainty

Establishing an appropriate long-term strategic allocation is one of the most important tasks that committees tackle. Fortunately, they are not doing this work alone; investment advisors typically provide support and guidance along the way. However, even the most well- designed policy faces challenges, particularly during periods of heightened volatility and uncertainty in the markets, that require tactical maneuvering. How should organizations balance the structure of a strategic allocation with the flexibility to make tactical changes?

A well-worded Investment Policy Statement (IPS) should address tactical changes. It needs to answer questions such as: who is responsible for identifying market changes, 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 within certain preapproved bands without seeking approval. These shifts should be geared toward managing short-term portfolio risks and mitigating the effect of extreme outcomes.

Measuring Success

Grading the success of a portfolio differs for each organization, but for everyone, measuring progress in supporting the overall mission is paramount. A review of the investment funds' performance, considering the stated objectives, guidelines, and policies, should focus on ensuring that 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, but 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 Global Bond). Even though the benchmark will not be an exact match, this comparison is designed to measure the impact of the strategic allocation, tactical moves, and security selection decisions made by the investment manager(s).

Responsible Investing

Many endowments and foundations want to invest responsibly by encouraging corporations to adopt sustainable, healthy business practices. But responsible investing means different things to different institutions—and being mission-aligned depends on what your mission is. To ensure decision-makers are all on the same page when evaluating different investment approaches, it's important to recognize that responsible investing strategies exist on a spectrum. And just as investors do not have to own every style box, they don't need to own every segment of the responsible investment universe. As with any asset allocation, consider a variety of equity styles, alternatives, and fixed income to diversify your exposure.

What's more, institutions are increasingly adopting formal policies addressing diversity, equity, and inclusion when it comes to their investment manager selection. Looking at the make-up of the managers who are actually selecting securities for your portfolios goes hand in hand with choosing a mission-aligned investment strategy.

For further reading, Fiduciary ESG Investing: Navigating the New Frontier provides a road map for fiduciaries as they explore a range of responsible investing considerations.

Each underlying investment strategy should also be measured individually against the appropriate benchmark to highlight 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 frequently a source of confusion because there is very little uniformity among investment managers. Often there are layers of fees, but 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 are fees for advice and servicing of the portfolio, including administrative and custodial services and costs that may or may not be readily disclosed. Committees should regularly review these expenses with their investment manager to confirm that they are appropriate.

A Fiduciary's Duty

Serving as a volunteer board or investment committee member is a great way to give back. But it also means that fiduciary requirements dictate acting prudently and in the best interest of the organization. Successful partnerships are built on having a clear understanding of responsibilities, risks, and ultimately, returns to meet the mission and objectives of the organization. Importantly, formalizing processes that underscore how to achieve these objectives is one of the best investments an organization can make (*Display 8*).

The Big Picture

With short-term trials present in any investment environment, it's easy to lose sight of the importance of establishing a long-term strategic asset allocation. In the short term, optimizing for risk and return through tactical allocation can add value, but setting a proper, long- term strategic allocation that considers a mix of asset classes and management approaches will provide the backbone to sustain an organization and meet its distribution goals over the long haul. Today that may mean moving beyond a traditional stock and bond portfolio, to one that uses diversifying, illiquid assets to enhance returns without a greater assumption of risk. It also means measuring outcomes, with the ultimate goal of achieving your mission.

DISPLAY 8: THE PATH TO BUILDING A SOLID FIDUCIARY FOUNDATION

1. Define Withdrawal Needs and Time Horizon
2. Set the Strategic Allocation: The Risk Budget
3. Agree on Policy Regarding Active, Passive, and Alternative Investments
4. Provide Flexibility for Tactical Allocation
5. Establish Benchmarks and Measure Investment Returns
6. Evaluate Total Fees and Expenses and Revisit Annually
7. Periodically Review and Refresh Investment Policies and Guidelines
8. Educate New Members on the Context and History of Prior Policy Decisions

Source: AB

Notes on the Bernstein Wealth Forecasting System^{SM}

The Bernstein Wealth Forecasting System^{SM} 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.

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