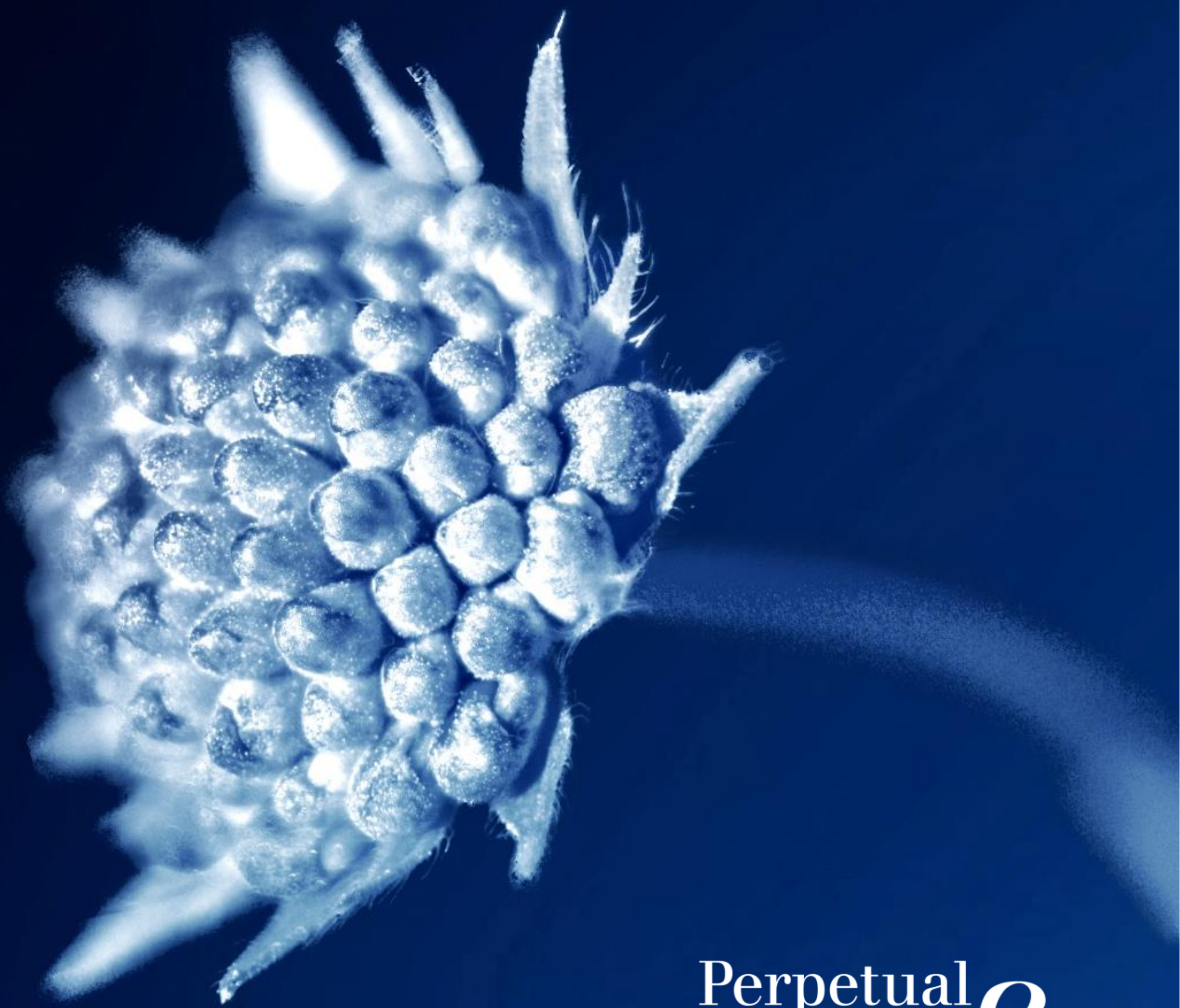
Perpetual Private

Asset allocation trends

in our not-for-profit portfolios – revisited



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In 2022 we investigated how different not-for-profit organisations thought about risk and return and how that played through into portfolio construction. The aim was to help investors assess their own investment goals, risk profiles and asset allocations to see if there were discrepancies worth further investigation. We recently revisited our client base to see if anything had changed.

Revisiting the 2022 analysis

Having just come through Covid, we assessed the objectives and portfolios of 195 not-for-profit investors that partner with Perpetual. This research was conducted on the 31 of December 2021 and at that time we found a lot of similarities between investors; however, there were important differences that impacted investment decisions. There were no universal approaches we found that should be adopted by all investors; however, we did recommend Investment Committees and Boards use the data in the report alongside the following questions as a basis for discussion on their own portfolios:

1. Does your investment objective align to your cash flow needs?
2. In the current market environment, do you have an appropriate exposure to growth assets?
3. Is your equity allocation diversified enough?
4. Have you considered alternative investments as an additional portfolio diversifier?

Fast forward two years...

...and a surprising amount has changed from an investment, markets and governance perspective:

The fall out of Covid and heightened levels of government spending during this period have led to interest rates being pushed up at a faster pace than any other time in recent history. This has impacted the risk and return profiles of different asset classes.

The balance of public and private assets has been shifting, largely driven by regulatory changes and ease of access to investors. This has resulted in a growth in private markets allocations across a spectrum of different investors as well as a changing opportunity set.

We've experienced an AI boom leading to expectations of increased productivity. This has led to astronomical growth in several tech companies operating in this space. A notable example is NVIDIA which on its own, had a market capitalisation bigger than most developed countries*.

Governance expectations across all sectors have been on the rise with heightened focus and scrutiny from the regulator; rippling through to private company and not-for-profit boards. This has led to increasing sophistication and independence of Boards and Investment Committees in the not-for-profit sector.

* as of 30 June 2024

? **Has any of this impacted how not-for-profit organisations are thinking about their objectives and portfolios?**

Methodology

When assessing any strategy – including an investment strategy – it's a good idea to see how similar organisations approach the issue. So, we have assessed the objectives and asset allocations of a cross-section of our not-for-profit clients to give a picture of how our investors are thinking about risk and return.

Please note, while investment decisions should not be made based solely on this research, we believe this analysis uncovers some interesting trends. This has led us to posing four new questions – found at the end of this paper – that your Board or Investment Committee can use to help you assess whether your investment strategy is appropriate for your needs.

We reviewed a cross section of our client base as at 31 December 2023. Our review covered 219 not-for-profit portfolios with a total of more than $3 billion invested and individual asset bases ranging from $250,000 to over $500 million. Investors that only held cash were excluded.

Number of not-for-profit clients assessed

FUM*	Number
0-$2.5M	67
$2.5M-$5M	46
$5M-$7.5M	28
$7.5M-$10M	21
$10M-$20M	30
$20M+	27

* Funds under management as at 31 December 2023

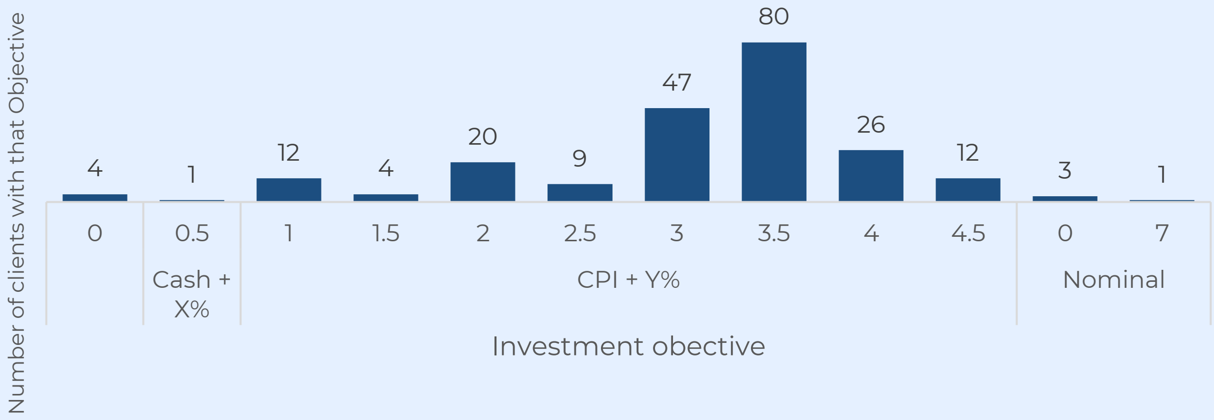
Source: Perpetual Private

Investment objectives

Not-for-profit investors are generally seeking to achieve a real (after inflation) return and so it's no surprise that most objectives are stated in the context of consumer price inflation (CPI). Additional returns above inflation can be distributed as an income. This structure aims to ensure the buying power of any regular distributions does not fall over time.

Some 96% of our not-for-profit investors are using an inflation+ objective. As you can see from the chart below, 70% are targeting returns of 3-4% above inflation. These findings are very similar to our last report.

Investors investment objectives



Source: Perpetual Private

Growth and defensive asset weightings

The allocation of assets between growth (such as equities, growth alternatives and real estate) and defensive assets (cash/fixed interest) is a key driver of total portfolio risk and return outcomes.

There is a difference in the weighting to growth assets between our smaller and larger portfolios; however, this difference has reduced between 2021 and 2023. The average growth weighting for portfolios with less than $5 million has increased slightly; and the growth weighting of investors with between $5-$10 million has moderated.

There are a few factors that could be driving this. An increased sophistication across the smaller investors is likely to have contributed to a greater risk tolerance leading to a higher growth allocation. Whereas for the larger investors, the new interest rate environment will have enabled some investors to reduce their growth weightings without impacting the probability of meeting their objectives.

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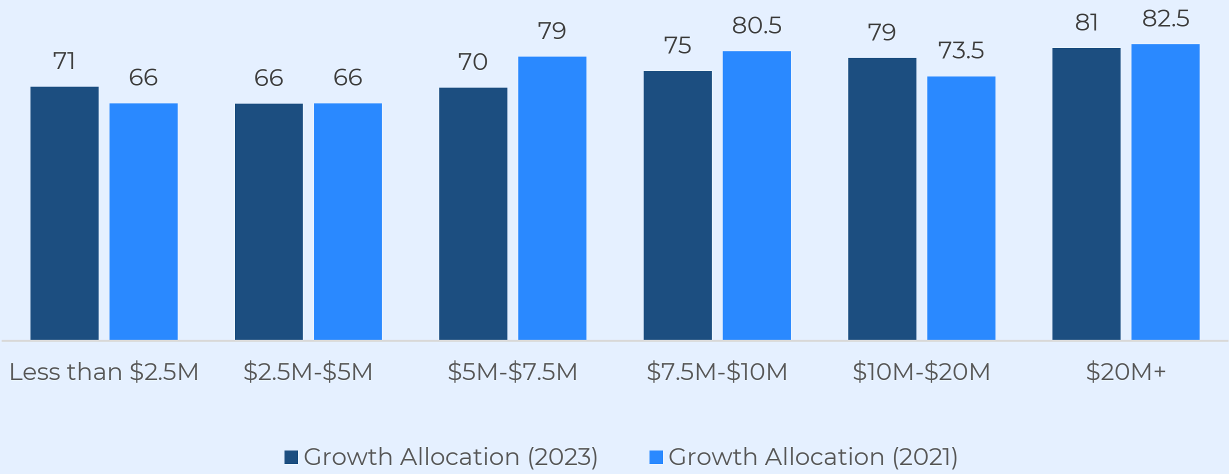
Investor growth weightings (%) by funds invested ($)



Source: Perpetual Private

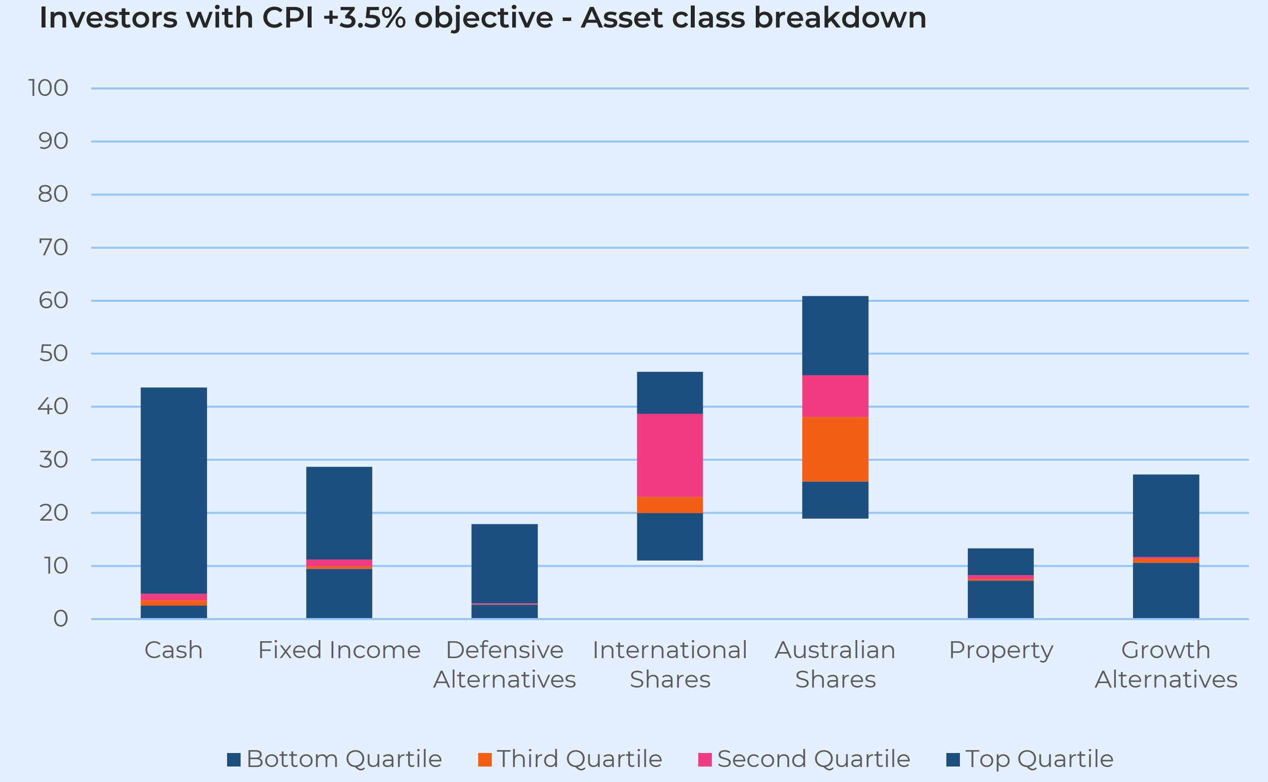
Same objectives, different asset allocations

A Strategic Asset Allocation drives 80-90% of all risk and return outcomes. Yet, as we delved into how growth and defensive allocations were broken down by asset class in our not-for-profit portfolios, we found a meaningful variation between our investors – even those with the same investment objective. As in 2021, it still appears not-for-profit organisations are taking different paths to achieve similar goals.

If we take the most common objective amongst our investors of CPI +3.5% as an example, the lowest and highest strategic asset allocation to different asset classes varied by more than 50%. This is shown by the blue bars in the chart below which indicate the extremes between the maximum and minimum allocations for each asset class.

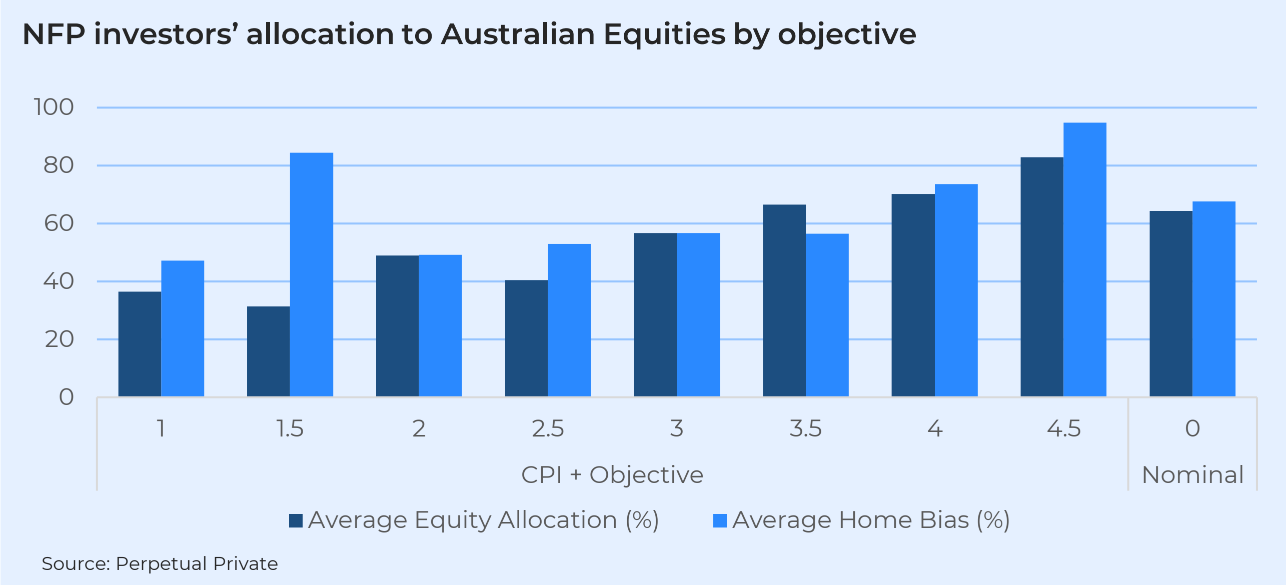
The third and second quartiles represented most investors and so where you see larger pink and orange bars in the chart, there was less alignment. This is true of international shares and Australian shares. It was also true of fixed income in the 2021 review; however, this distribution has disappeared in the most recent set of results.

In 2021, those with higher strategic asset allocations to fixed income tended to have lower or no allocations to alternatives. Since then, we've seen an increase in investors allocating to fixed income and cash, most likely driven by a better return profile looking forward. The difference between equity holdings, on the other hand was driven by relative weightings. Whilst the overall weighting to equities was broadly consistent, the allocation between Australian and international shares differed. This is consistent in the latest findings.



Source: Perpetual Private

Home bias



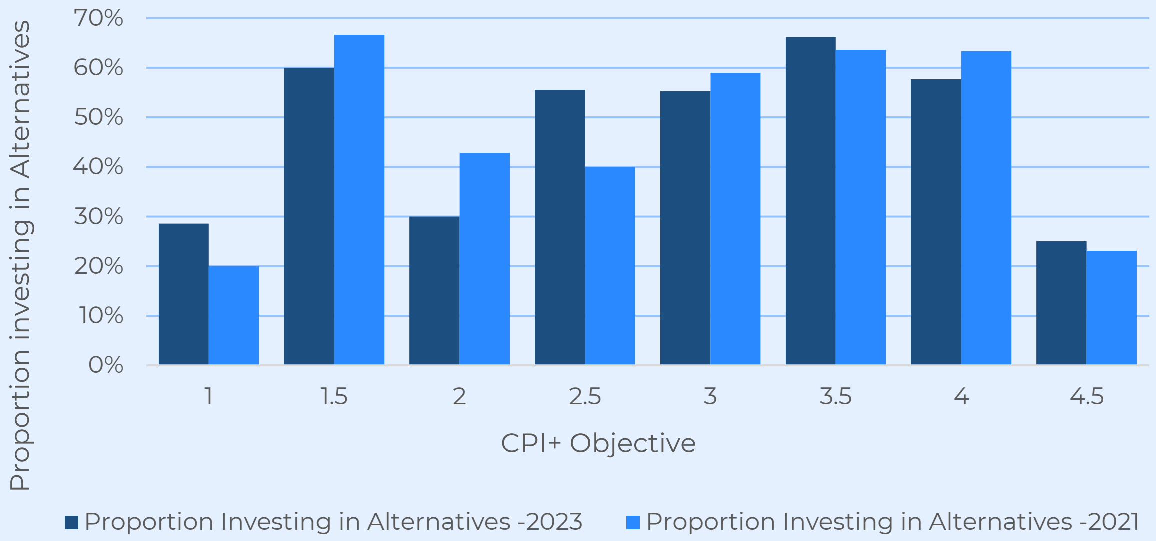
An overweight to Australian equities (home bias) is common practice in our not-for-profit portfolios because of the tax benefits of franking credits. However, trade-offs do exist. Australian equities are less diversified than international equities and therefore introduce greater investment risk. For example, our market is heavily skewed towards financials and materials and has limited exposure to the big tech businesses so important in the US and the high-tech manufacturing companies that dominate in Europe and Japan. By having a more concentrated portfolio that doesn't contain important sectors that contribute to the global economy, portfolio returns could be impacted and have been in the last few years with tech driving growth in international markets.

Investors need to assess these trade-offs when making asset allocation decisions and this will lead to differences. Due to the benefits of franking credits, some level of overweighting is likely to be beneficial to most not-for-profit investors.

Alternatives

Across the portfolios that were assessed, 52% had an allocation to alternatives. This is the same as our 2021 review. The most frequent allocation was 15% with the majority holding 10% in growth alternatives (such as private equity and hedge funds) and 5% in defensive alternatives (such as private credit). A more detailed breakdown of alternatives holdings is shown in the chart below.

Proportion of NFP investors allocating to alternatives



Source: Perpetual Private

Allocation to alternatives has been increasing in recent years; however, between 2021 and 2023 there has not been any material changes in our investors' portfolios. We believe the reason for this is twofold:

1. Traditional fixed income securities and cash are more likely to deliver more attractive returns over the short to medium term than they were expected to two years ago, driving up allocations across portfolios.
2. Our client base were early adopters of alternatives and so most clients that could be allocating, were already.

Clearly there are risk and return trade-offs as alternatives are further up the risk spectrum than traditional fixed income, and in some cases equities. For example, alternatives are less liquid and often more complex than traditional assets. However, they do have risk and return drivers that differ from more traditional asset classes. This means you can add an allocation of alternatives to a not-for-profit portfolio without significantly increasing the investment risk so long as the portfolio remains sufficiently diversified.

Alternatives are also more complex and less liquid than traditional asset classes and so only investors with a long investment time horizon should consider them. That said, as most not-for-profit investors are investing in-perpetuity, alternatives may be worth consideration.

Conclusions

Whilst it has only been two years, the landscape has changed and that has resulted in portfolio rebalances. The most prominent examples are fixed income and cash – two asset classes that were returning very little only two years ago. This had led to underweight positions across many investors' portfolios.

In light of this, we have posed four new questions for investors to consider as part of their Committee and Board meetings:

When is the last time you reviewed your strategic asset allocation?

Was it when interest rates were expected to stay lower for longer and if so; are you under allocating to fixed income?

International equities have been a huge driver of return outcomes over the last few years.

Are you over prioritising income at the expense of total return?

Now interest rates are expected to stay higher for longer; you can achieve a CPI+ objective with a lower allocation to growth assets.

Could now be the time to be taking some risk off the table?

Alternatives continue to look attractive from a total portfolio risk and return outcome perspective for those investors that do not need 100% portfolio liquidity.

As such, should you be increasing your allocation?

Want to optimise your portfolio?

All not-for-profit organisations want to get the most from their investments – it can make a real difference to the communities they serve. If you have questions around your portfolio's asset allocation, home bias or alternatives holdings, or have any other questions on different approaches to investing, please get in touch with your financial adviser or contact us.

More information

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Emily specialises in working with wholesale and institutional investors, helping them to generate better risk adjusted returns through tailored investment analysis, portfolio construction, and governance advice.

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