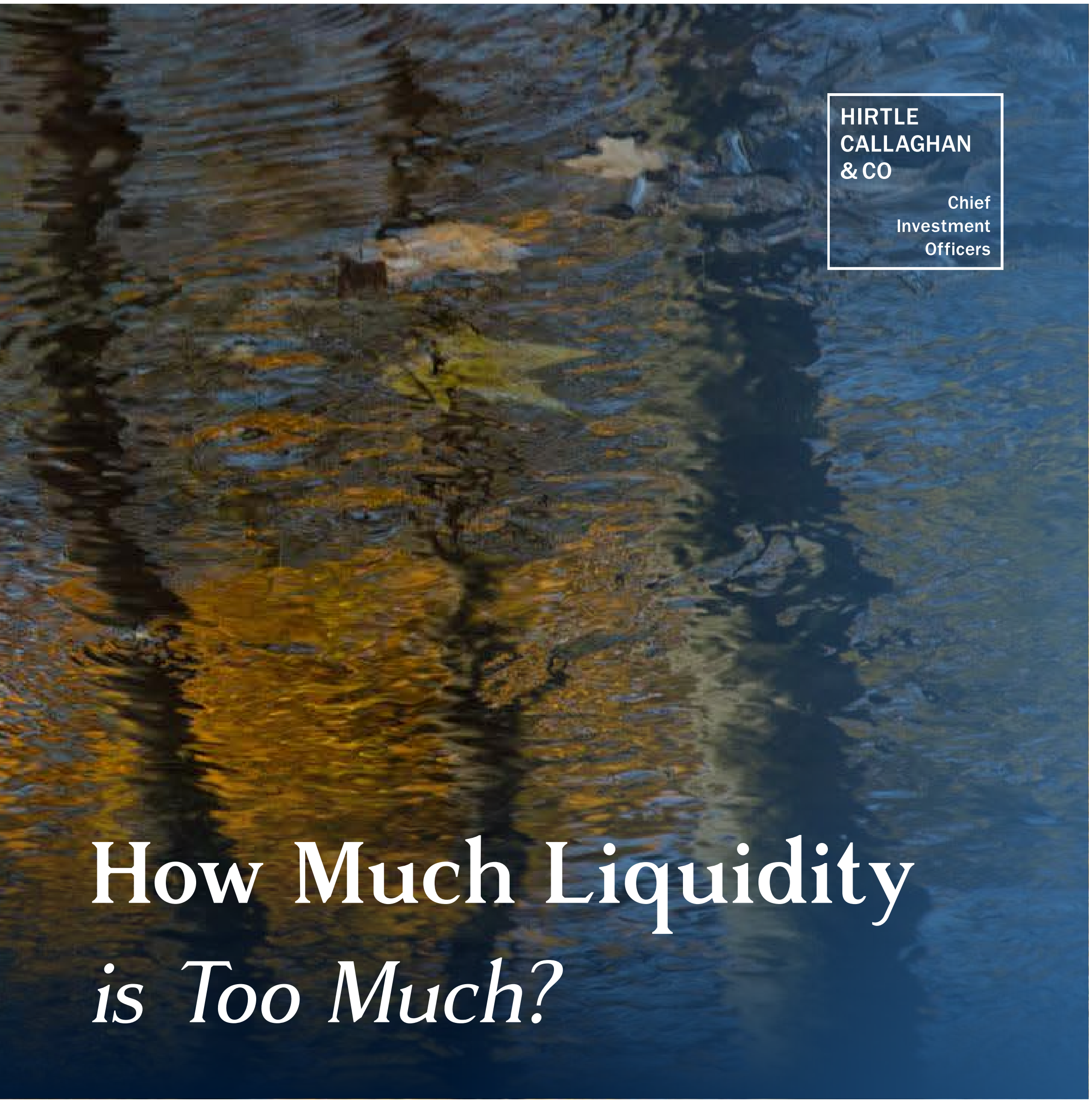


HIRTLE CALLAGHAN & CO
Chief Investment Officers

How Much Liquidity *is Too Much?*

Return expectations across all asset classes have declined considerably over the past twenty years. Nowhere has this decline been more significant than in fixed income where the yield on the 30-year Treasury has declined from 5.8% in 2000 to 1.6% today. With negative real interest rates, it has become much harder for endowments to meet their return targets and to maintain purchasing power over time. Institutions have two possible responses. They can:

1. Increase exposure to equities and illiquid assets to increase their likelihood of meeting long-term return targets; or
2. Maintain their current risk profile, accept lower returns and reduce their spending rate.

Few institutions can afford to lower their spending rates or underperform their long-term targets. To support future growth, we believe institutions should rethink their liquidity profile and their allocation to bonds and move out the investment spectrum to risk/return options that best fit their risk profile. In this paper, we discuss how to think about your organization's liquidity needs and weigh the inherent tradeoffs between liquidity and returns.

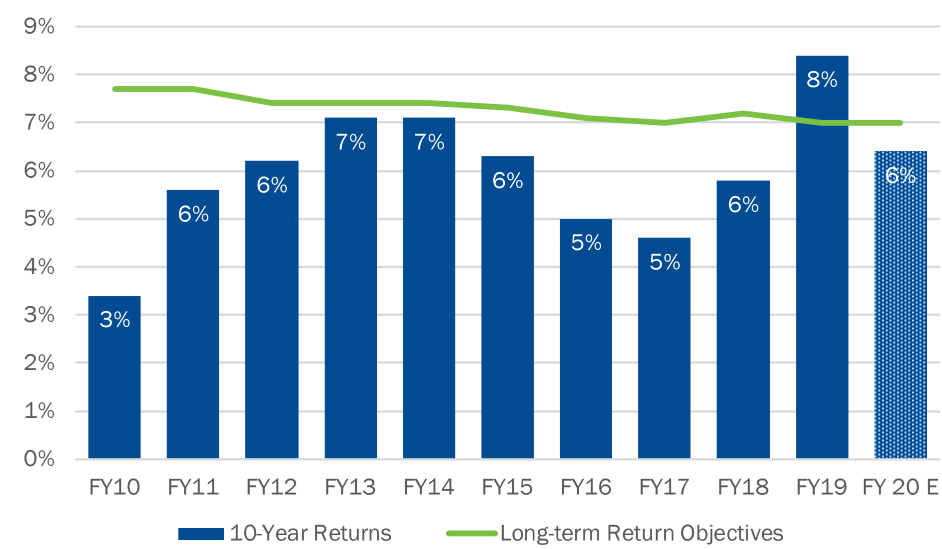
“Successful investing is about managing risk, not avoiding it.”

– Benjamin Graham

What is Liquidity?

Liquidity refers to the ease with which an asset, or security, can be converted into cash without affecting its market price. The easier an instrument is to convert to cash, the more liquid it is. Stocks and bonds can generally be liquidated to cash fairly readily. In a normal market environment, investors typically assume they will be able to sell them at a fair market-based price should they need liquidity. However, liquidity can dry up in periods of market dislocation as we witnessed in March of this year. In this case, investors may be forced to sell assets at discounted values. While this tends to happen infrequently, the consequences of a true liquidity crisis are dire. To guard against this scenario, small- to medium-sized endowments generally prioritize liquid assets, specifically bonds, to create stability and a safety net.

10-Year Average Endowment Returns vs. Objectives



Source: NACUBO. 10-year returns and long-term return objectives are aggregated from survery responses.

The value associated with liquidity is further inflated by human behavioral biases. Loss aversion is a well documented bias in behavioral finance. In the face of uncertainty, investors are so fearful of losses they can be overly focused on avoiding them rather than on generating long-term returns to meet overall investment objectives. Investment Committee members, acting in their role as fiduciaries, likely have an even greater predisposition to be loss averse which manifests itself in a desire to be overly liquid.

Are Concerns About Liquidity Warranted?

No. In reality, few organizations have actually experienced liquidity crises despite having gone through three significant market crashes in the past twenty years - the Tech Bubble, the 2008 Global Financial Crisis and most recently the COVID-19 pandemic. Instead, organizations are facing a return crisis. For the past decade, non-profits have struggled to meet long-term return objectives as demonstrated in the chart above, threatening their future viability.