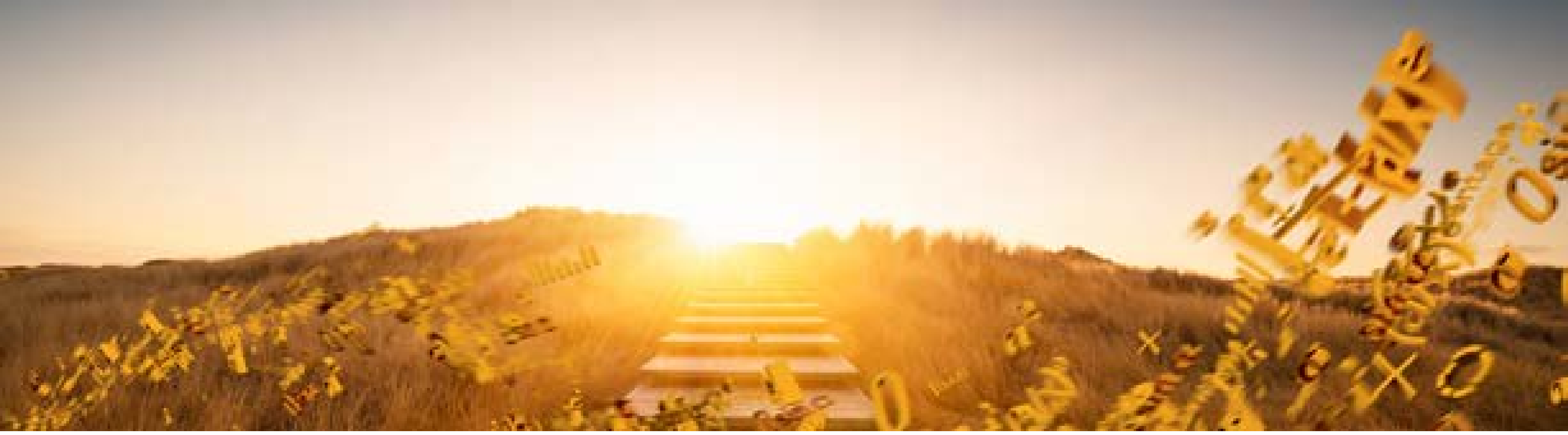

Volume I 2019

Connections

Aon Hewitt Investment Consulting's Newsletter for Non-Profits

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connections

noun | con•nec•tions | \kə - ˈnek-shəns

1 The act of building relationships and associations between groups of like-minded non-profit investors and partners
2 A communication tool developed to deliver insights into topical issues relevant to non-profit investors
3 A platform for non-profit investors to access the broader resources of the Aon and the Non-Profit Solutions Team

Welcome!

Welcome to the Connections: The Non-Profit Newsletter and our first issue of 2019. Our focus for this edition is building an awareness of key issues for the new year. Tapan Datta and Lila Han address a few critical questions regarding the market, how we view the potential impact and outcomes of the global economy and implications for non-profit fiduciaries. Chris Foster describes the important role that custodial banks fill for non-profit institutions, particularly in an increasingly complex world. Beth Gallagher and I discuss the growing importance of corporate philanthropy in Part 1 of a two-part article. And, we have Part 2 of a two-part interview with Meredith Jones on the evolution of responsible investing. In addition, we are happy to announce the newest member of our non-profit team, John Stuntebeck, who has worked with non-profit organizations for the past 20 years.

We are participating in a number of industry conferences in the coming months and have included a list in this newsletter. We hope to see you at some of these events.

We value your opinion, feedback and suggestions for future articles. Please let us know your thoughts. Here's to a wonderful 2019.

Thank you,

Heather Myers
Partner, Non-Profit Solutions Practice Leader

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Empower Results®

2019: A year for better or worse?

by Tapan Datta and Lila Han

While we recognize that market psychology is not impervious to the flow of economic and market fact, the interpretive process on how good or bad things are is what brings magic and mystery to markets. What will happen to economic conditions is hard to call, but predicting market interpretation is vastly more difficult. With that all-enveloping caveat on the market outlook, here are four questions, the answers to which will have a bearing on what sort of a year this is. As is readily apparent, these are interlinked, interlocking questions.

Will trade stay at skirmish level or move to actual war?

We are now getting to a point where further escalation in trade conflicts could bring major economic consequences. Currently, the kind of trade conflict and policy uncertainty we have seen has impacted corporate cost structures and business investment planning, going by stock price behavior and comments made by company managers at quarterly analyst briefings. Its impact at the global macroeconomic level in pulling economic growth down significantly is not clear yet, however. That said, what is apparent is that further escalation could potentially make a big difference. The fact that trade fears have hurt markets and that stocks of the most internationally exposed sectors/companies are down the most may now restrain more rhetorical ratcheting up from the U.S. Yet, looking hard at the epicenter of the trade conflict – the U.S.-China relationship, the bipartisan support in the U.S. for a hard line on China and the difficulty the Chinese authorities will face in making significant concessions - does not suggest any major easing of tensions is likely. Trade conflict may be a slow burner rather than a market destroyer, but it is unlikely to go away, and as we commented last year, will likely keep coming back to shock markets from time to time.

Will Europe and China weaken further?

Europe's economic activity levels have fallen back from the previous year, but only to what is widely thought to be trend or underlying growth rates rather than anything worse. In the absence of new shocks, there is no obvious reason to suspect much worse to come this year. Policy normalization in the form of less stimulus from the European Central Bank is coming, but very slowly. Of course, new shocks in the form of a poorly managed Brexit process, more Italian troubles and a further loss of support of the political center in the EU are all live risks. How much they will exert pressure on the markets in 2019 is difficult to take a view on. Overall, the balance of risks still tilts to the negative given the range of things that could potentially go wrong. As for China, our view remains that though aggregate growth rates will remain on the soft side, there is enough navigation room using monetary policy to keep growth supported above a notionally minimal level of danger (>5%). While there are undoubted policy conflicts between a notional economic activity target and the wish to reduce the reliance on debt-financed investment spending, we need to remember that the process of restructuring and reform has now been ongoing for a few years with some partial success. The key risk to this view that major downside risk is absent comes from the possibility that trade conflict escalates markedly. Overall, we are working with the view of the Chinese economy looking soggy at a headline level but making some progress at the ground level, i.e. a slow improvement in growth quality.

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2019: A year for better or worse? (cont'd.)

by Tapan Datta and Lila Han

Will the US soft land its economy and profits? Will rate worries return?

Part of the uncertainty has been about the aftermath of the tax stimulus package in the U.S. that boosted economic growth and bottom lines markedly over the past year. What lies beyond is still a matter of conjecture. A "soft landing" to economic growth rates of perhaps 2 percent and small but positive growth in corporate profits (consensus is currently seeing mid-singl- digit growth in U.S. S&P 500 earnings per share in 2019) would be benign and well received, especially given that the market has de-rated to valuation levels which no longer look substantially extended.

The complication comes from the fact that the U.S. economic expansion has been running for a very long time, policy interest rates have risen significantly from their lows, and relatively high rates of corporate leverage carry risks if activity slows markedly. Domestic political uncertainty in the U.S. is currently contributing to the bad market mood but this is, with luck, temporary. Our view has been that U.S. late-cycle risks are difficult to wish away because they are so dual-sided. If inflation pressures surface, worries over further rises in interest rates could easily return. On the other hand, if the market grows more fearful that the Federal Reserve has already "overtightened," there are obvious difficulties too. It is this uncertainty that feeds the volatility that we have been seeing and it is hard to see this go away in 2019.

Will market sentiment stay downbeat?

In the way that most problems were ignored earlier, last year saw a dramatic reversal in the market's interpretation of news flow. The change in global liquidity conditions from loosening to tightening in 2018 has clearly been the linchpin of this sea change in market psychology. Could those animal spirits return again? Maybe, but they are unlikely to last. Yes, a market rebound would not surprise at all at this time – Jerome Powell, chairman of the Federal Reserve, quite reasonably pointed out last week that the markets have been recently "ahead of the data" in pricing in downside economic risks. If these do not materialize, there is some potential for clawback of lost ground. However, this still looks to be mostly a tactical opportunity and should be used as such. Some rebalancing to risk asset target weights is fair for well-diversified portfolios but for others less well buffered against market pain, it would be an opportunity to divest risk.

We continue to see recent market behavior as characteristic of a transition environment that has already moved us well beyond the best times for risk assets. Even if we are not quite ready to run for the hills and take maximum bearish positions now, this year is not offering any obvious route back.

Implications for non-profit fiduciaries:

- Keep an eye on managing downside risk with the return of market volatility.
- (Re-)Deploy capital to higher alpha potential strategies with less correlated/ less liquid/uncorrelated return sources to traditional equity and bond risks.
- Broaden the context for your portfolio decision making by accounting for the organization's enterprise financial goals/ needs.

News from Aon Corporate

Our team will be participating at these upcoming conferences. We look forward to connecting with you!

2019 Foundation Leadership Forum
AGB (Association of Governing Boards of Universities and Colleges)
Jan. 27-29
Fort Lauderdale, Florida

2019 Endowment and Debt Management Forum
NACUBO
Feb. 13-15
New York City

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Don’t Overlook the Role of the Custodian

by Chris Foster

What is a Custodian?

While much of the focus of fiduciaries is on asset allocation, manager selection and consultant selection, don’t overlook the role of the custodian. A custodian is an institution that provides services including holding, valuing and transferring securities; receiving interest and dividends; and providing notice of corporate actions. These services are most frequently provided by large global custodian banks or through fund companies/brokers. While both types of institutions satisfy the minimum requirement of being a “custodian,” there are differences in client experience and asset security.

A custodian is an institution that provides services including holding, valuing and transferring securities; receiving interest and dividends; and providing notice of corporate actions.

Unless a non-profit has a relatively small amount of assets (i.e., under $25 million) with limited investments in commingled funds (i.e., 1-3 mutual funds), it is highly recommended that the custody bank model be utilized.

Why the Bank Custodian Model Makes Sense.

In contrast, to a broker dealer services, non-profit organizations can benefit from the bank custodian model due to:

- Centralization of assets: Bank custodians are able to hold all the assets of the trust on their books, allowing for a single client service contact and consolidated reporting, generally leading to a higher degree of administrative efficiency for the non-profit organization.
- Additional asset security: Bank custodians hold assets in the client’s name (“nominee name”), as opposed to the broker/dealers that hold it in their own name (“street name”). Holding assets in a nominee name protects assets from creditors if the financial institution becomes insolvent.
- Elevated quality of reporting and optimized work flow: As the single provider holding all assets, the custody bank provides consolidated reporting along with performance reporting and is the central party for cash movements, trades, standing instructions, etc. The custodian is also the central party to spearhead the settlement of the transactions, as opposed to having multiple mediators.
- Sophistication to comprehensively support numerous and complex investments: The additional complexity of diversifying investments (such as illiquid assets, direct holdings in foreign markets, derivatives, custom unitized investment pools, etc.) requires a different asset servicing structure.

The Aon Custody Consulting Team consists of custody industry veterans that are 100 percent dedicated to custody and investment operations. The team maintains strong relationships with the leading custody banks, and can work with non-profits of different sizes to determine the best custody partner depending on your circumstances.

The Future of Corporate Philanthropy: Part 1

by Heather Myers and Beth Gallagher

This is part one of a two-part article on corporate philanthropy. In this article we discuss the evolution of corporate philanthropy. Part 2 will be published in the subsequent non-profit newsletter and will provide a framework for structuring corporate philanthropy.

> Today, there is greater recognition than ever before that giving back to society is not only good for the recipients but it is good for the company.

According to the Foundation Center, there are more than 2,600 corporate foundations in the United States with total corporate giving amounting to $5.5 billion annually (2013).* In addition, there are many more companies that have direct charitable giving programs, and other social impact initiatives, such as pro bono and volunteering, that occur outside of the formal structure of a foundation. Today, there is greater recognition than ever before that giving back to society is not only good for the recipients but it is good for the company — in terms of brand building, talent retention and improving key evaluation metrics such as corporate social responsibility ("CSR") and environmental, social and governance ("ESG").

Over the past decade, we have seen a significant shift in corporate giving — as corporate profits have risen, so have charitable giving rates. The latest *Giving USA*[1] report suggests that giving by U.S. corporations rose by 8 percent in 2017 alone. In fact, there is a general understanding that businesses, particularly larger companies that operate in multiple jurisdictions and are part of and/or exert influence over global/regional supply chains, have a responsibility to operate in socially responsible ways. We have seen increased focus on two broad metrics: CSR and ESG. CSR initiatives are generally acknowledged to play a role in employee engagement, and ESG metrics are increasingly acknowledged as investment and financial performance factors. Sometimes one may eclipse the other in how CSR and ESG interchangeably may refer to the same types of socially responsible business best practices, programs, initiatives and metrics that are being adopted by companies.

A review of reports produced by the Committee Encouraging Corporate Philanthropy (CECP) from the past 10 years reveals a number of clear trends that have emerged in corporate philanthropy. These include:

- Cash giving, but not necessarily via corporate foundations;
- Giving plus, where cash is contributed along with pro bono work or in-kind donations of products or services;
- International giving – as companies become increasingly more global, so do giving efforts;
- Alignment with core business objectives and core competencies;
- Focused giving – fewer, larger gifts in service of specific issue areas or causes for deeper impact;
- Informed giving – voice of the customer and community is sought out and goals are more stakeholder driven;
- Collaborative – more intra-industry, more cross-sector partnerships (e.g., nonprofit and nongovernmental organizations, academia, public sector, other companies); and
- Measurement and reporting – return on investment to the company and the community, articulating demonstrable business value plus social outcomes.

Given the dynamic context in which corporate giving programs operate and the variety of both internal and external factors to which they need to be responsive, it's not a surprise to see these trends. Some of the challenges most impacting society and businesses today stem from competitive disruption, a changing workforce/automation, impacts of climate change, a growing wealth gap, and natural resource scarcity, to name just a few.

**Source: thebalancesmb.com, November 6, 2016*
[1] *Giving USA 2018 https://givingusa.org*
[2] *Committee Encouraging Corporate Philanthropy ("CECP") Giving in Numbers Reports, 2009 and 2018 editions http://cecp.co/home/resources/giving-in-numbers*

The Future of Corporate Philanthropy: Part 1 (cont'd.)

Meanwhile public expectations for businesses to be responsive to social issues are increasing. Stakeholders want to know how revenue is being earned, what a company's position on social issues is and what their ultimate impact is on the community and the world at large. Performance is no longer being measured solely in terms of quarterly financial results, but in these broader terms of CSR and ESG metrics as noted above. A recent survey from Globescan shows that there is still a gap between the public's expectations for companies with regard CSR and the actual performance of such.[3]

Aon's recent Global Risk Management survey[4] further underscores concerns around stakeholder perception; it indicates that two of the top ten risks are damage to brand and failure to attract top talent. Brand equity, mostly composed of customer loyalty, prestige and positive brand recognition, is considered part of a company's intangible assets and it directly impacts a company's bottom line.

There are a number of dynamics driving concerns about attracting talent such as demographic and economic factors, but workplace features is one of the main drivers. Aligned CSR and corporate philanthropy programs can help mitigate the risks around brand and talent. According to the Cone Communications 2017 CSR Study, "CSR continues to be a differentiator in the minds of consumers… Communicating strong CSR practices consistently reaps reputational and bottom-line benefits year-over-year."

It isn't surprising that the macro socioeconomic forces driving public discourse are also playing out at the micro level among corporations to engage in issues beyond the pure financial.

Aon's 2016 Workforce Mindset Study found that a company's environment and social responsibility and a positive reputation with customers rank in the top five in importance of what employees want from their employer. Among top 10 differentiators, the survey found, "Is a Strong Fit with my values" ranked No. 5. Differentiators are important factors for employers to consider as they can distinguish and set themselves apart among stakeholders, not the least of which are customers and employees.

It isn't surprising that the macro socioeconomic forces driving public discourse are also playing out at the micro level among corporations to engage in issues beyond the pure financial. As corporate philanthropy continues to evolve, good corporate citizens are becoming more proactive to provide transparency, focus, and demonstrable impact in society. Good CSR practices can directly affect how a corporation is perceived by all of its stakeholders –not only by its employees, but also by its investors, consumers and the general public. Corporate philanthropy, when done well, is key in amplifying the strength and differentiation of a company's CSR.

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[3] *www.globescan.com (CSR Expectations and Performance 2015)*
[4] *Aon Global Risk Management Survey, surveys roughly 1600 c-suite executives globally (2017)*

Featured Focus on Responsible Investing: Part 2

We recently sat down with AHIC's Head of Responsible Investing, Emerging and Diverse Managers, Meredith Jones, to talk about industry trends, opportunities and challenges, and what's keeping her busy these days. Below is part 2 of the conversation, continued from the last issue of Connections.

1. Is there one particular investor group/type that is driving the growth in responsible investing?

Not really. Interest is fairly widespread, although we have noticed that the more interactions an organization has with millennials, the more likely the issue is to come up. In addition, the closer an organization is to having a true mission, the more likely it is to have RI interest or implemented RI policies and investments.

2. Institutional memory reminds us that while RI gained great interest at the peak of the last market cycle, discussions were put on the back burner when the financial crisis hit. Should investors that are exploring RI be concerned that these discussions could dry up again? Or could this time be really different?

The advent of ESG integration is a real plus for RI this time around. If, as early research indicates, a company with strong ESG factors will tend to outperform and do so with less volatility, it makes sense in good times and bad to seek out these types of investments. In addition, during a financial crisis, philanthropy can decrease as donors feel the pinch of economic crisis. However, with more impact investment opportunities available, it may be that philanthropically inclined investors can have their cake and eat it, too. Now they can choose from a larger menu of investments that could generate an investment return for them as well as their broader community. I would think these investments would also continue to be attractive options in a market downturn.

3. Tell us what are the challenges or hurdles you see investors face when considering RI implementation. How have we been helping clients address them?

The main challenge investors face is a lack of understanding about the broad range of solutions involved in RI. For example, one person on an investment committee may understand RI only in the context of divestment or negative screening, and that can put the kibosh on all types of RI activities within that organization. Part of our role is to help investors understand the broad universe of RI investments and how each of them could (or can't) work within their investment objectives. This means we must provide clear definitions and use cases for investors, as well as materials they can circulate to a broader group of stakeholders to obtain buy in. We've published a number of pieces recently aimed at doing that, including an animated, five-minute video explaining the various types of RI. We've also recently rolled out ESG integration ratings for buy-rated fixed income and equity managers in an effort to help investors understand where they may already have exposure to RI.

4. Is there any correlation to the growth in RI at the same time that gender lens investing, diversity investing and the like have gained greater attention?

As I mentioned before, diversity and RI are close cousins. I think that both are getting more attention now as it has become increasingly clear how gender, diversity, and ESG/RI are tied to corporate performance and overall economic prosperity. At the end of the day, the majority of our clients are fiduciaries and they have to obtain the best economic outcome for their stakeholders. Focusing on these types of issues has the potential to help.

5. How do you see your role evolving over the next 3-5 years? Where do you see the RI industry or hope to see it in the near-term and longer term?

I think we will get to a point where ESG integration is a given among money managers, and where the range of values-based investment tools, including impact investments and socially responsible investments, will be vast and completely customizable. Investment managers from the largest firms like BlackRock and State Street to the smallest startups are paying attention to RI and developing funds to address investor needs and pressing global issues. As a result, I think it's a really exciting time to be in responsible investing.

We are excited too! We look forward to engaging with more non-profit organizations in this dialogue. Meredith, thank you for sharing your perspective with us.

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