CLA Outcomes Conference:
Ten Questions for Christian Investment Portfolios

March 2023

Inflation, rapidly rising interest rates, and geopolitical concerns helped make 2022 a historically challenging environment for financial markets. Both bonds and stocks posted double digit declines, leaving most investors with precious few places to hide. Markets stabilized in the fourth quarter and have rebounded modestly from 2022 lows, but it remains important to look forward and evaluate current risks and opportunities. As such, we have prepared ten questions that Catholic fiduciaries should be asking about their investment portfolios.

Question #1: How do you define risk?

Risk in investment portfolios is most commonly associated with volatility, as measured by standard deviation of returns. However, we suggest fiduciaries consider a more comprehensive risk framework for Christian investment portfolios that includes the following elements:

- **Fiduciary Risk:** The risk that the portfolio is not managed with sound governance processes and procedures, or is not monitored effectively

- **Market Risk:** The risk that the portfolio's growth will be hindered by excessive volatility, large drawdowns, and/or permanent loss of capital

- **Longevity Risk:** The risk that the portfolio will not grow sufficiently to cover its long-term spending obligations

- **Alignment Risk:** The risk that the portfolio is not invested in a manner consistent with your mission and Christian principles

Question #2: How sensitive is your portfolio to interest rate movements?

2022 offered a stark reminder that bonds aren't always a "safe" asset in a portfolio, as historically low starting yields combined with a rising interest rate environment to produce outsized negative returns, particularly for longer-dated securities. As we enter 2023, the yield curve is inverted, where yields on short-term bonds are higher than intermediate- and long-term securities, an abnormal occurrence that is typically a harbinger of a recession to come. The Federal Reserve recently decelerated the pace of interest rate increases, but is still expected to enact additional hikes, meaning there could be more negative risk in the bond market. However, that risk is mitigated by the fact that current yields across the maturity spectrum are significantly higher than they were a year ago, providing some welcome cushion against declining bond prices. Fiduciaries should be aware of the interest rate risks in their portfolios and explore opportunities to adjust their positioning to best reflect the current environment.

Question #3: Have you explored alternate sources of portfolio income?

2022 demonstrated that publicly traded stocks and bonds are not always negatively correlated, and a building a diversified portfolio may require exposure to additional asset classes. While opportunities in the public fixed income markets were limited heading into 2022, fiduciaries who explored alternate sources of income in their portfolio were rewarded. For example, private debt, where lenders extend credit directly to borrowers, can benefit from rising interest rates because such investments are typically floating-rate rather than fixed-rate. Unconstrained fixed income funds had the ability to react more quickly to the changing environment in 2022 and adjust their interest rate sensitivity accordingly. Income-generating real estate remained relatively stable—although there may be some short-term pain yet to be felt in that asset class.

Question #4: How protected is your portfolio against inflation?

Inflation had not been a legitimate threat to investment portfolios in the years following the Global Financial Crisis, but in 2022 supply/demand mismatches and COVID stimulus reignited inflation. While inflation can have a negative impact on both equity and fixed income investments, other asset classes have the potential to benefit from an inflationary environment. Commodities, for example, were a lone bright spot for investors in an otherwise dismal 2022.

Question #5: Are you comfortable with/aware of the downside risk in your portfolio?

2022 was a vivid reminder of how quickly downside risk can manifest in an investment portfolio. Large losses are a significant impediment to long-term compounding of returns, requiring even larger gains to get back to breakeven. The recent modest rebound of financial asset prices has created an opportunity for fiduciaries to re-assess their comfort level with the potential downside risk in their portfolio and adjust the asset allocation as necessary.

Question #6: What is your optimal mix of actively managed and indexed strategies?

We believe that active management can add value net-of-fees over a long-term time horizon, but there are periods when active management struggles to outperform market indices. Passive investing may carry hidden risks, as the S&P 500 in particular has become highly concentrated. A mixture of active and passive strategies is appropriate for most portfolios, with several factors impacting what that optimal mix should be for any given portfolio.

Question #7: Are you overvaluing liquidity?

Bond yields have risen from their historical lows, and equity valuations have moderated relative to forward-looking earnings estimates, but 2022 illustrated the pitfalls of investing solely in publicly traded instruments. The inclusion of less liquid marketable alternative and private market assets can potentially help improve risk-adjusted returns, lower volatility, and offer a degree of downside protection in a portfolio.

Question #8: Is your portfolio managed in alignment with Christian principles?

Socially Responsible Investing has moved beyond simply excluding certain holdings and evolved toward investing in strategies where a manager may use ESG/SRI principles in security selection and/or actively engage with companies in an attempt to influence them to change their practices, and/or otherwise create positive impact. **Note: We will not recommend any investment vehicle solely because it is Socially Responsible, and we strongly believe in adhering to sound fiduciary principles when evaluating any investment product for inclusion in a portfolio.**

Question #9: Is your asset allocation in alignment with your long-term goals?

2023 Capital Market Assumptions have changed materially from the previous year, with many asset classes now forecasted to produce higher returns over the next decade. As such, it is important to review your asset allocation in the context of your long-term liabilities and short-term cash flow needs and determine if any changes need to be made to reflect the realities of the current environment.

Question #10: How do you evaluate your investment advisor?

While Christian investment portfolios are generally not subject to ERISA, it is still considered best practice to periodically evaluate your investment advisor as part of your ongoing fiduciary responsibility. A thorough RFP process can provide opportunity to gain new perspectives, enhance service, or reduce fees. An independent third-party diagnostic study, or Summary Investment Review, can be a viable alternative to a full-scale RFP process.

Conclusion

This article represents a cursory overview of these important questions impacting Christian investment portfolios, but the answers to these questions will be specific to your organization's unique circumstances. We will discuss all of these challenges with you in greater detail at our session "Ten Questions to Ask About Your Investment Portfolio" on March 29, 2023 at the CLA Outcomes Conference.

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