BNY MELLON
WEALTH MANAGEMENT

2022 Capital Market Assumptions: Key Insights on Planned Giving

Every year, BNY Mellon Investment Management develops capital market return assumptions for approximately 50 asset classes around the world. These forward-looking assumptions are based on a 10-year investment time horizon and are intended to guide investors in developing their long-term strategic asset allocations.

BNY Mellon uses these assumptions to construct expected return and risk estimates used to model a variety of portfolios, including life income vehicles. As we enter the third year of the COVID-19 pandemic, investors are faced with negative real interest rates, rising inflation, slower earnings growth, increasing volatility, elevated valuations, and expectations of tighter monetary policy.

In this challenging environment, it is especially important to make disciplined asset allocation decisions based on prudent long-term return expectations and objectives. The era of the one-size-fits-all 60/40 portfolio of U.S. stocks and bonds is over. To achieve the specific goals for each planned gift, not-for-profits must adapt by incorporating a wider array of asset classes within portfolios. This includes diversifying fixed income holdings, expanding the mix of equities and adding alternative asset classes like real estate and commodities. These strategies, combined with disciplined implementation and a long-term perspective, will help to ensure that each planned gift fulfills its donor's intent and supports the mission of the charity.

Here's a look at some of the key findings of our 2022 Capital Market Assumptions report, as well as the implications for planned giving.

Weaker equity market returns due to slowing growth rates and stretched valuations - Emerging markets attractive over the long-term

After strong performance by U.S. equities in 2021, our return projection for equities moving forward is revised modestly lower. A reduction in real growth expectations, lower income assumptions, and a decline in valuations are expected to prevent a repeat performance of the past two years. While the U.S. is expected to lead the way for equities in 2022, our outlook points to higher returns in emerging markets over the next 10 years. As near-term downside risks from slowing economic growth due to the pandemic recede over the next 12 to 18 months, investors should consider adding to emerging market equity exposure. Although the asset class tends to be more volatile than U.S. equities, emerging markets equity is relatively attractive due to its positive economic growth rates, favorable demographic trends and reasonable valuations.

Traditional fixed income anchors likely to generate negative real returns - Diversify to enhance yield and protect against rising rates

While investment grade fixed income provides a historically valuable and consistent hedge against equity drawdown and volatility, we expect it to be a lagging source of total return and income yield in the coming years. The return of the U.S. bond market over 10 years is consistent with the yield of the market at the start of the period. With interest rates and credit spreads at or near all-time lows, interest rate hikes expected and persistent

inflation present, real return for investment grade fixed income is likely to be negative for the foreseeable future. Investors in need of income and protection from rising interest rates should add exposure to less interest rate sensitive sectors within fixed income. These sectors include unconstrained and global bond strategies, high yield bonds, bank loans, preferred securities and emerging market debt. Active management of exposure to interest rate risk and credit risk will be extremely important for investors who aim to mitigate the impact of low yields and rising rates on their assets.

Inflation is expected to increase moderately - Increase exposure to inflation hedges

Due to constrained supply chains, a tight labor market, higher consumer demand driven by the pandemic reopening, fiscal stimulus and easy monetary policy, inflation rates in the U.S. are at levels not seen in nearly 40 years. We expect that overall inflation will settle in a range of 3% - 3.5%, higher than the Fed target rate of 2%. The Fed has already announced a plan to hold inflation in check by reducing asset purchases and raising short-term interest rates in 2022. At the same time, disinflationary factors such as technological innovations, productivity gains and aging demographic trends will constrain inflation from moving higher. An environment of moderately elevated inflation, combined with moderate economic and earnings growth, is supportive of our outlook for more modest yet positive equity gains over the next 12-18 months. In addition to maintaining an overweight exposure to global equity to combat inflation, we believe additional exposure to inflation hedges like real estate equities, commodities and inflation-linked bonds can protect the purchasing power of investors' assets.

Exhibit 1: 2022 Capital Market Assumptions

		10-Year Annualized Expected Return		
Asset Class		**2021 Return Assumption**	**2022 Return Assumption**	**Change in Assumption**
Equity	U.S. Large Cap Equity	6.5%	5.9%	-0.6%
	U.S. Mid Cap Equity	7.0%	6.4%	-0.6%
	U.S. Small Cap Equity	7.7%	6.9%	-0.8%
	International Developed Equity	7.0%	5.8%	-1.2%
	Emerging Equity	8.6%	7.6%	-1.0%
	Global REIT	6.5%	5.9%	-0.6%
Fixed Income	U.S. Treasury Bills	0.6%	1.1%	0.5%
	U.S. Treasury	0.5%	0.9%	0.4%
	U.S. Aggregate	1.0%	1.2%	0.2%
	U.S. Investment Grade Credit	1.3%	1.5%	0.2%
	U.S. Intermediate Municipal	0.4%	0.9%	0.5%
	U.S. High Yield	2.7%	1.9%	-0.8%
Diversifiers	U.S. Private Equity[1,2]	8.5%	7.9%	-0.6%
	Hedge Funds - Equity Hedge[1,2]	5.0%	4.9%	-0.1%
	Absolute Return[1,2]	3.1%	3.2%	0.1%
	Commodities	2.4%	3.0%	0.6%
Economy	U.S. Inflation	2.4%	3.0%	0.6%
	U.S. Real GDP Growth	2.9%	1.9%	-1.0%
	U.S. 10-Year Note Yield	2.7%	3.2%	0.5%
	U.S. Short-Term Interest Rate	1.7%	2.2%	0.5%

Source: BNY Mellon Investor Solutions. Data as of September 30, 2021.
[1]Consistent with the Representative Index, returns are net of management fees.
[2]The Representative Index is not investable. Returns are based on manager averages. Actual results may vary.

Expected returns for gift illustrations

One of the most important inputs for any gift illustration is the expected rate of return. Small changes to the expected rate of return will have a significant impact on the outcomes shown in a gift illustration. Exhibit 2 shows the expected returns for different risk/return profiles based on BNY Mellon's 2022 Capital Market Assumptions and hypothetical portfolios comprised of U.S. Large Cap Equities and U.S. Aggregate Bonds. As you can see, we expect that a traditional 60/40 balanced portfolio will struggle to generate stable capital growth over the next decade. We believe that these expected returns provide reasonable and realistic results when used in gift illustrations. Not-for-profits should update the rate of return assumptions in their gift illustrations to provide donors and other stakeholders with realistic expectations for gift outcomes.

Exhibit 2: Hypothetical Portfolios 2021 vs. 2022 Assumptions

	Fixed Income	30% Equity/ 70% Fixed Income	50% Equity/ 50% Fixed Income	60% Equity/ 40% Fixed Income	70% Equity/ 30% Fixed Income	Equity
2021 Expected Return	1.0%	2.7%	3.8%	4.3%	4.9%	6.5%
2022 Expected Return	1.2%	2.6%	3.6%	4.0%	4.5%	5.9%
Change	**0.2%**	**0.0%**	**-0.2%**	**-0.3%**	**-0.4%**	**-0.6%**

Source: BNY Mellon Wealth Management. Data as of December 31, 2021.

Realistic expectations for returns and growth over the next 10 years

Investors have benefited from more than a decade of strong equity returns that have lifted markets and portfolios to all-time highs. For the 10 years ended in 2021, a hypothetical 60/40 portfolio comprised of U.S. Large Cap Equities and U.S. Aggregate Bonds generated an annualized return of 11.14%. After such an extended period of impressive returns, it is important not to extrapolate or assume that this will continue indefinitely, especially when modeling planned gifts for prospective donors.

In general, planned giving vehicles have annual payout rates in excess of 5%, sometimes higher. This high hurdle rate means that planned giving portfolios must generate levels of return higher than 5% to maintain the original value of the gift. If one also hopes to preserve the purchasing power of the original gift amount, then the required rate of return is even higher. With an increase in the expected rate of inflation to 3% and fees of 0.5% to 1%, a planned giving vehicle with a 5% payout has a hurdle rate of approximately 9%. Based on our 2022 CMAs, we do not expect any portfolio or asset class to generate this level of return over the next 10 years. If growth of principal over time is not achievable, then not-for-profits must clearly define the objectives that are achievable for their organization and their donors. By setting reasonable expectations, organizations can better inform stakeholders and donors about the potential outcomes of a planned gift.

Appropriate investment objectives - High opportunity cost of being too conservative

With risk-free returns in cash and government bonds at or near zero and fixed income investments projected to generate negative real returns over the next 10 years, the opportunity cost of being too conservative for long-term investors is very high. Investors must balance the short-term drawdown and volatility risk associated with emphasizing growth over stability and income, with long-term risk of not achieving the financial and philanthropic objectives of a planned gift. Time is one of the most powerful forces that affects investment returns. In general, portfolios with a long-term time horizon (>10 years) are less sensitive to short-term market disruptions because they have time to recover unrealized losses. In a low expected return environment like today, investors must be willing to accept some short-term risk in exchange for long-term rewards. If your time horizon is long (>10 years), then, all else equal, your portfolio should emphasize growth over stability and income. Not-for-profits should carefully assess the impact of growth, stability and income allocations for planned gifts to ensure that the probability of meeting the objectives of both the charity and the donor are maximized.

Importance of active portfolio management

As investors face the challenges of a post-pandemic world of low returns and increased uncertainty, we believe the combination of timely asset allocation shifts, broad diversification, and the discipline to stay invested over the long term will be more important than ever. Taking advantage of opportunities and managing risk through asset allocation and consistent implementation has proven to be the most effective means of achieving long-term investment goals. Incorporating strategies and asset classes that provide protection from rising interest rates and elevated inflation, combined with the appropriate emphasis on growth for investors with long-term objectives will help not-for-profits to maximize the impact of their planned giving assets.