Investment Models for the Management of Small to Mid-Sized Endowments

Some of the largest educational endowments, including those of Harvard, Yale, Princeton, Cambridge and Oxford universities, have developed successful and highly respected investment approaches for protecting and growing investment portfolio assets over the long term. However, the "endowment model" is by no means a panacea for all investors as it has taken its own knocks through the recent financial turmoil. But the three simple principles of 1) high static rick level (i.e. no market timing), 2) multi-asset class diversification with high illiquid allocation and 3) focus on independent, entrepreneurial owner-run managers selected through deep due diligence remain nearly essential components of any good investment strategy. Many smaller endowments embrace these principles as fundamental to their own investment programs.

This white paper addresses the predicament many small to mid-sized educational endowments face (with assets below $1bn) as they seek to get the performance benefits of the endowment investment model without the same resources of their richer peers. Nearly all small educational endowments run on tight budgets with all costs generally referenced against such things as how many additional professors could be secured with any savings. As a result, most investment programs are staffed with few internal full time investment professionals. The cost of a qualified Chief Investment Officer and just three staff can run easily well over $1m. Many smaller endowments attempt to substitute full time staff for an all-volunteer investment committee comprising talented school alumni who are veteran investment professionals willing to donate a few hours a quarter to the endowment. One can look across the hundreds of US and UK endowment committees and see this attempted arbitrage on investment talent in action. This is good news for any endowment.

The bad news is that the volunteers tend to be very busy people who struggle to donate much more than a few hours a quarter to the endowment. For this to work, investment strategies must be constrained to what can be achieved with these short bursts of involvement. Investment committee meetings have to be very effective and nothing can go wrong in-between these meetings that requires additional time that they do not have. In many cases, the constraints put on the investment strategy come in the form of static asset allocations, limiting exposure to more traditional investment opportunities, asset classes and geographic markets and holding onto asset managers beyond their "sell-by" dates.

These constraints generally have portfolio performance implications. Against a backdrop of an increasingly complex and volatile investment environment, more legal, tax and regulatory intervention into the investment world, and greater concerns about the endowment growing sufficiently to cover the school's spending requirements, the demands on investment committees are outstripping the time Investment Committee ("IC") members have to deliver the required investment acumen to fulfil their fiduciary responsibility.

When the school approaches this "tipping point" it is normally confronted with a decision on how best to make that step change to a more professionally managed endowment. The key decision is one of hiring in-house investment staff ("build") vs. outsourcing to independent investment advisors ("buy"). We will discuss these and two other approaches: the "Consultant Model" and the "Hybrid Model" (internal staff plus consultant).

The "Build Model": In the build model, the IC focuses primarily on building and maintaining its own internal capacity to manage the school's endowment. This includes:

- Recruiting, compensating, housing, and supervising a CIO and adequate investment staff
- Establishing budgets and compensation structures for the investment staff and/or CIO
- Resourcing and supervising investment operations (an array of decisions and actions from establishing trading counterparties to risk control policies and procedures)

The IC may decide to staff up an investment office but not recruit a CIO, which almost certainly means the IC will have to devote some time and energy supervising the staff. In either case the total annual budget is likely to be well over $1M for even a modest staff and a solid CIO will expect at least a mid-six figure total compensation package. And with the limited staff, the IC must still define what constraints should be placed on the investment strategy. For example, a team of 3-4 should not be expected to be sufficiently expert on all asset classes (equities, private equity, fixed income, absolute return, credit, commodities and property) and all geographic markets for sourcing the best of breed asset managers in each asset class. A $2m staffing level may start to approach the required team for an unconstrained investment strategy but with, for example, a $300m endowment this requires the IC to be confident that that team will add more than 0.67% on average to the annual investment returns.

The "Buy Model": In the full version of the "buy model", the IC focuses primarily on selecting and monitoring an external professional advisory firm to which it outsources the endowment investment function across the full portfolio. The relationship between the IC and that firm can vary across a spectrum. The most typical approach has the IC still setting investment objectives and high-level policy including the long term strategic asset allocation, while the external investment advisor normally inputs to asset allocation debate, but takes responsibility for all the other activities including tactical asset allocation and asset manager identification, due diligence, on-boarding and on-going monitoring. A capable investment advisor will also take primary responsibility for reporting on endowment performance to the IC and main Board including manager-by-manager benchmarking and full portfolio performance attribution. The best investment advisor will bring macro-economic insights and a clear roadmap for navigating through today's dynamic investment landscape. Its toolkits should look through each asset manager's portfolio to provide the endowment will an accurate assessment of the collective set of risks that are being taken and should be armed with sensible portfolio overlays to hedge against extreme events which could do lasting damage to the endowment value. The investment advisor's operational support will include transaction execution, custody management, currency hedging, private equity capital call management, portfolio rebalancing, cash sweep monitoring and other heavy lifting that generally accompanies more sophisticated modern portfolios.

Investment advisors themselves range from very large firms that service pension funds and other substantial institutions as well as school endowments, to more focused firms that specialize in providing a bespoke service to smaller endowments and foundations. The choice along this spectrum presents tradeoffs highlighted by the following questions:

- Are you dealing with the most senior members of the firm?
- Is your relationship manager also an investor, or just your relationship manager?
- Does the IC have direct access to other senior investment decision makers in the investment advisor's firm?
- Is the service provided as "one size fits all" or designed around the school's specific needs in terms of its risk and volatility, liquidity and funding profile, appetite for international exposure and currency risk, inflation sensitivity and the like?
- Can the investment advisor "afford" to seek out smaller and niche managers whose AUM best fits their strategies and who are often hungrier and more likely to produce superior returns than their very large brethren who can happily live on their management fees ("afford" in the sense that the large allocators need to align with managers who can scale to the size of the allocator's client base, often including giant pension funds).

Investment advisors vary in terms of cost from 0.30% to 1.00% of assets advised depending on the breadth of the role and investment strategy focus. They almost always look after the entire portfolio and may not charge fees on certain legacy assets. The longer established investment advisors should be able to demonstrate from auditable track records whether their performance contributions more than pay for their fees.

The "Consultant Model": A third option is the "consultant model". Consultants normally provide some but not all of the services provided by an investment advisor. The most prominent consultants tend to charge an annual fixed fee, from as little as $50,000 for a skeleton service to well above $1m a year for comprehensive services. With a consultant, the decision to "pull the trigger" on a new manager or the redemption of an incumbent manager rests ultimately with the IC. Frequently, consultants will help run screens, coordinate final meetings among managers with the IC, and facilitate decision-making conversations, but stop short of a formal recommendation. Because consultants are normally not "paid for performance" they have less incentive to seek out the more difficult to find or to access managers who may stand a higher probability of producing superior returns. The larger consultants tend to lead their clients toward the large, long-established institutional asset managers that often have raised too much capital, and tend to just track their indices, struggling to outperform. It is difficult to generalize about consultants as they occupy a diverse territory of services and products on offer, but a sophisticated IC can normally observe the difference between a true investor (which a solid investment advisor should be) and a firm that stops short of a full set of investment capabilities, including investment operations, and avoids sharing the performance risk of the endowment through its compensation structure.

The "Hybrid Model" (Internal Staff plus Consultant): This model is frequently seen and can work to a degree. However it is imbedded with its own somewhat perverse dynamic: the more assertive the consultant is the less likely the endowment will be to attract and retain fully capable internal investment talent, and the more assertive the internal team is the more likely the consultant will be marginalized in its value-add to the endowment. The hybrid model will almost inevitably result in paying twice for some degree of overlap in skills and activities. In either case one is feeding two mouths, often with a suboptimal result.

Conclusion: So the choice of model for small to mid-sized endowments comes down to weighing the need to have an investment strategy which avails itself to the full range of investment opportunities and the most effective means to serve that need. In what might have in the past been considered a normal investment environment, a perfectly viable endowment investment strategy was one that embraced a fairly static portfolio construction and was concentrated in a small number of asset managers from the traditional equity and bond world. The present investment environment has many sophisticated endowment investment committees concerned that portfolio returns from any investment strategy are unlikely to deliver sufficient returns to fund their school's annual budget and protect capital against the ravages of inflation. Our view is that "normal" returns are more likely to be achieved where investment strategies are more nimble, where decision makers can respond quickly to the changing domains of investment risk to avoid the greatest downdrafts, while exploiting the many opportunities that emerge from chaotic market situations like the present.

At no time in recent history has it been more important to find and access those extraordinarily talented independent asset managers who are best able to profit from what are largely uncharted investment waters. Whether through the "build" or "buy" alternative, this requires relatively large specialist teams who demonstrate deep insights into each asset class and whose scope spans the globe to find the best asset managers.

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