

Is the Endowment Model Broken?

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Why should we care about large endowments?

- Considered thought leaders
- Strategy widely emulated by pension funds, wealth management firms, etc.
- Proliferation of outsourcing firms run by former endowment managers

Why emulate large endowments?

Annualized return for the 10 years ending 6/08

- Yale 16.3%
- Harvard 13.8
- Wilshire 5000 3.6
- TUCS Median 6.1



What is the “endowment model?” Characteristics of Large Endowments

- Equity Orientation
- Modest Fixed Income Exposure
- Early adopters of alternatives
- Substantial allocations to alternatives including illiquid asset classes

Big versus Small Asset Mix

	% of Portfolio	
	>\$1b	<\$25mm
Domestic Equity	14%	38%
Int'l Equity	12	13
Alternatives	61	13
Fixed Income	10	27
Cash	3	9



Large Endowment Asset Mix Harvard University 2010

Domestic Equity	11%
Non-US Equity	11
Emerging Mkt. Equity	11
Private Equity	13
Absolute Return	16
Commodities	14
Real Estate	9
Bonds	13
Cash	2

Is the endowment model broken?

Fiscal 2009 Returns by Endowment Size

>\$1b	-20.5%
\$501-\$1b	-19.8
\$101-\$500	-19.7
\$51-\$100	-18.6
\$25-\$50	-18.5
<\$25	-16.8
Average	-18.7%

Ouch!!

Fiscal 2009 Return

Yale -24.6%

Harvard -27.3%

Average endowment -18.7%

But, an 80/20 mix of global equity and bond indices
would have fallen 22%.



24/7 Wall St. 2010 Best And Worst Managed University Endowments: Harvard, Yale, And Duke Worst

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The National Association of College and University Business Officers released its analysis of the financial performances of the endowments at 842 institutions which have a combined \$306 billion in assets. The report compared figures for the fiscal ending mid-2009 to those for the mid-2008 period. The average endowment lost 18.7% of its value, net of fees, between July 1, 2008 and June 30, 2009.



I argue that there is no “endowment model.”

- Diverse asset mixes
- Significant differences in implementation
- Varying degrees of resources and sophistication
- Wide dispersion of performance

Diverse Asset Mixes

	% of Portfolio		
	Penn	Harvard	Yale
US Equities	17.5	11	10
Non-US Eq.	26.2	22	15.2
Private Eq.	6.3	13	20.2
Absolute Ret.	25.2	16	25.1
Real Assets	6.9	23	29.3
Fixed/Cash	17.9	15	0.2



No one “endowment model”

But many top endowment managers share a number of core principals or values



Shared Values

Diversification

- Multiple Asset Classes
- Multiple Styles
- Geographic diversification
- Manager diversification
- Currency Exposure
- Counterparty
- Custodian/prime broker

Equity orientation

- 80-95% exposure to equities (broadly defined)



Shared Values continued

As a perpetual fund, an endowment should be able to tolerate **reasonable volatility**.

- Use of smoothing formulas for spending
- Typically target standard deviation of 10-12% which is consistent with expected volatility of 60/40 mix
- Severely tested in 2008-09 due to endowment budget reliance, increase in correlations, and “fat tails.”
- The concept of “reasonable” volatility is being re-examined everywhere. Are we fighting the last war?



Shared Values continued

Endowments should allocate significant assets to markets deemed to be “**less efficient.**”

Characteristics of less efficient markets

- Imperfect or asymmetric information
- High barriers to entry-fewer participants
- Illiquid/high transaction costs
- Highly specialized managers



Shared Values continued

Endowments should take advantage of their **unique attributes**

- Long time horizon-time arbitrage
- Illiquidity
- Unique access and resources- i.e. alumni network, faculty research
- Tax exempt status



Shared Values continued

Focus on strategies in which managers can **materially influence outcome**

- Private Equity
- Real Estate
- Hedge Funds
- Activist Equity Managers



Shared Values continued

Value Orientation

- Value bias among long only, long-short managers
- Distressed investments
- Flexible mandates



Shared Values continued

Flexibility/opportunism

- Broad asset class definitions
- Large ranges of permissible exposure
- Opportunistic component of portfolio
- Managers with skill in multiple categories



Shared Values-summation

- Enduring principles
- Still allow for significant differences in implementation
- Despite one bad year, track records are impressive



What's all of the hoopla?

If these values remain valid, why all of the concern?

In fact, there are a number of lessons from the 2008-09 period that we should all learn



Lesson 1

Current asset allocation models underestimate risk due to increases in correlation during periods of stress as well as “fat tails.”

Expect

- New generation of models
- Cottage industry providing “tail” insurance. If many institutions choose to buy tail insurance, what will the impact be on returns?



Lesson 2

True diversification during periods of stress comes from allocations to fixed income and cash. Yet, most large endowments have very modest weightings.

- Expect return to more balanced portfolios
- Focus on Treasuries
- Focus on cash-is it truly liquid?

Monthly Correlations 1/79-5/08

	Bar Agg	S&P 500	RU 2000	EAFE+EM	Wil. REIT
Bar. Agg	1	0.225	0.127	0.145	0.19
S&P 500		1	0.805	0.589	0.494
RU 2000			1	0.536	0.618
EAFE+EM				1	0.337
Wil REIT					1

Monthly Correlations 6/08-2/09

Bar. Agg	1	0.658	0.545	0.847	0.446
S&P 500		1	0.971	0.87	0.853
RU 2000			1	0.829	0.932
EAFE+EM				1	0.724
Wil. REIT					1



Lesson 3

Most institutions didn't stress test either their budgets or portfolios to understand the impact of 3 sigma events.

- Major concern-let's not over-learn this lesson if the result is excessively conservative portfolios and lower expected returns



Lesson 4

Cash flow models used to make allocations to illiquid investments blow up during periods of acute stress

- Models assume return of capital on older funds
- “Denominator” effect
- Need to stress test allocations assuming accelerated capital calls during a period in which distributions dry up
- Should we have larger cash positions on a permanent basis?

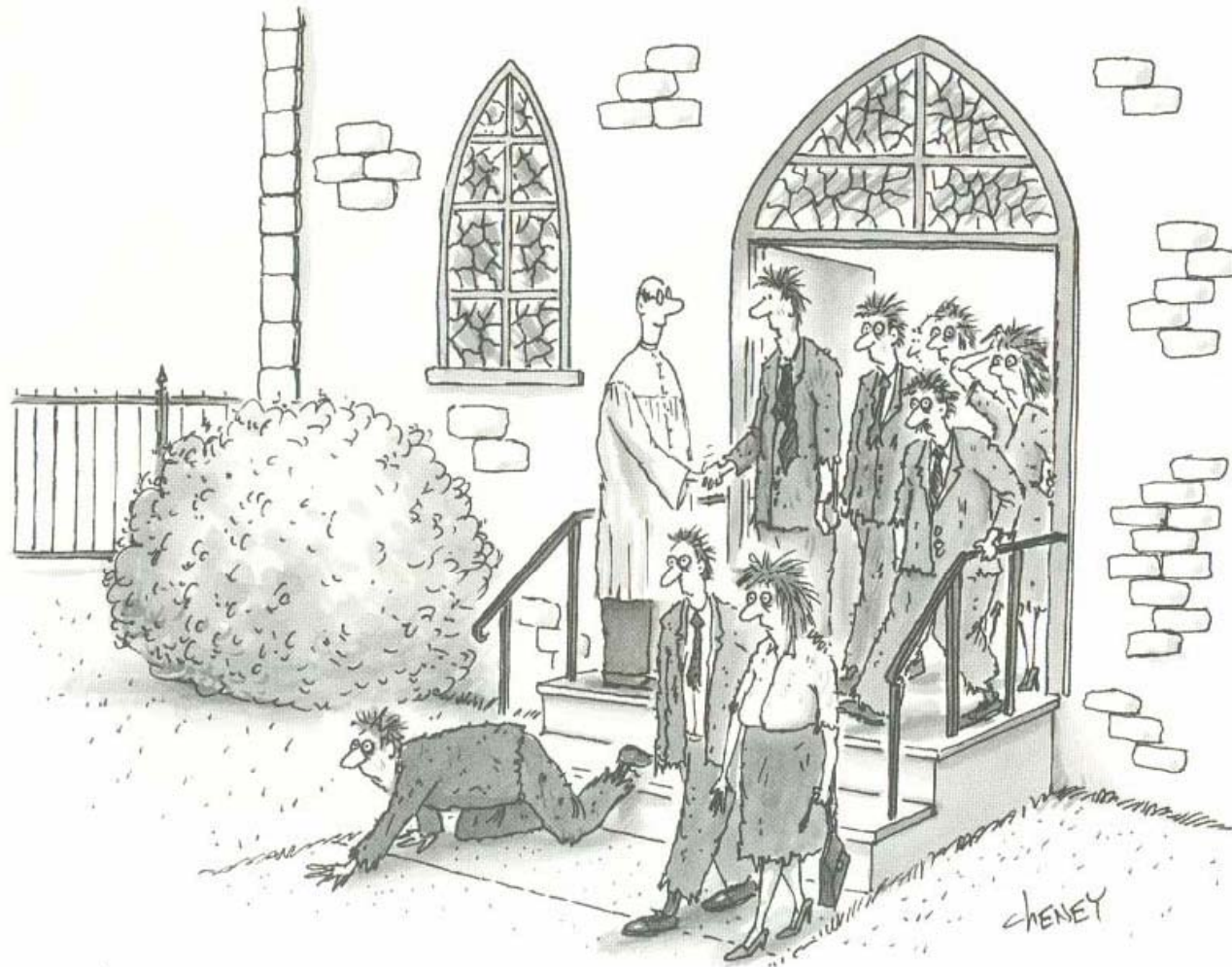


Lesson 5

Operational details are really important

- Who holds securities?
- Are liquid assets really liquid?
- Who are counterparties?

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"Excellent sermon."