
# The Endowment Model: Key Considerations

UC San Diego
RADY SCHOOL OF MANAGEMENT
The Brandes Center

## EDITOR'S NOTE

Bob Maynard and Steve McCourt, CFA debated the merits of the endowment model in late March 2023. Here, we share excerpts from their discussion as well as comments gleaned from email exchanges with our panelists after the actual debate.

This report was edited by Robert Schmidt (RS), Executive Director of The Brandes Center.

To watch a recording of the actual discussion, visit this link.

## EXECUTIVE SUMMARY

Among the key points each panelist shared:

**Steve McCourt (SM)**

→ Successful endowment model investors generally understand the complexity of the approach and have experience and resources to manage them.

→ One of the biggest mistakes an investor can make is adopting a strategy that they or future constituents won't be able to adhere to in future years.

→ Investing in public markets is generally a passive endeavor—even if you hire an active manager, because the day-to-day management of the companies rests with others. Private investing offers more control and, thus, often provides greater opportunities for better-than-public market returns.

→ The endowment model likely will have higher returns over a longer period, typically 10-20 years, and generally lower risk vs. a traditional 60-40 allocation.

**Robert Maynard (RM)**

→ Historically, equity-type investments likely will get you 5% to 7% returns above inflation and bonds will get you 1% to 3% over the long term. If you're in that swing zone, there is no compelling reason to go to the endowment model.

→ I am very suspicious of "risk budgeting" or "risk portfolio rebalancing" or any other quantitative "risk" based approaches. They have not worked.

→ The question is: Is now the time to do an endowment versus a 60-40 portfolio? And, in my mind, it's neither.

### OUR PANELISTS

**Robert Maynard**

Bob is the former Chief Investment Officer at the Public Employee Retirement System of Idaho (PERSI). During his tenure, he helped build PERSI's assets under management from about $2 billion to more than $24 billion. Bob also is a founding member of The Brandes Center's Advisory Board.

**Steve McCourt CFA**

Steve is Managing Principal and co-CEO at Meketa Investment Group where he directs the firm's business strategy and execution. In 2023, Meketa celebrates its 45th anniversary as an independent, employee-owned investment consulting and advisory firm. Steve is also an Industry Advisory Council member with the Kroner Center, an investment-focused research center at UC San Diego's Rady School.

**RS: What type of investor is suitable for the endowment model and how do you know if you have the right structure to implement the model?**

SM: That question is a very critical one, because the endowment model, for all of its benefits and considerations that I'll express, certainly requires that an investor accept a higher degree of complexity, and the monitoring and work that goes along with managing that complexity itself is a consideration for investors. I think there are two types of investors who are appropriate to consider the endowment model.

For the first prerequisite, culturally, the investor using the endowment model has to understand and appreciate the complex investments that you're going to own. Otherwise, if investments go sideways in the future, you're likely going to abandon the strategy, probably at the wrong time.

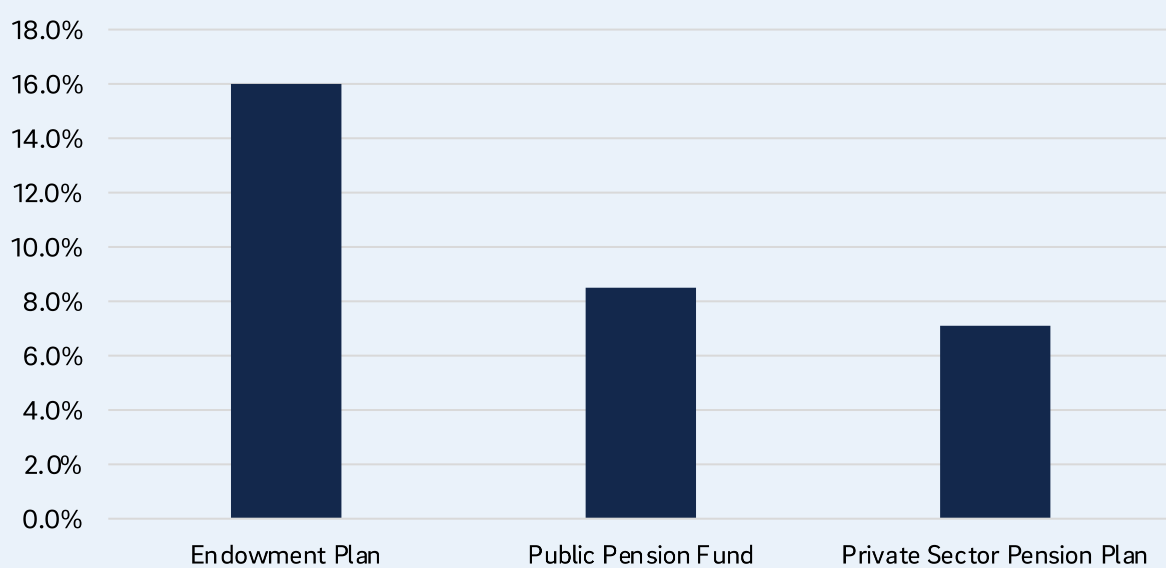
The second is that an investor needs to be more resource focused, because the endowment model involves many complex, underlying strategies and mixes of strategies. Successful investors tend to be very experienced and most often have a large investment staff or outside investment advisors who manage the money managers for them. So, there's an oversight and monitoring hierarchy that goes with the endowment model in most cases.

**RS: David Swensen wrote that it's not an approach where you can get your toes wet. Do you agree?**

SM: I think most things in life are shades of gray. You can definitely integrate parts of an endowment model. You can start it with a small allocation and build up.

[As shown in Exhibit 1, target private equity allocations differ by type of investor.]
RM: Swenson had started the process at Yale in

**EXHIBIT 1 | Average Private Equity Target Allocation by Investor Type (as a % of AUM)**




Source: Meketa and Preqin, as of July 2022 the late '80s. When I got to Idaho in '92, it was very clear that there would be no way I would be able to get the same resources or staff as Yale. Secondly, we were subject to the Freedom of Information Act requests which are a disaster if you're trying to do the endowment model and complex investments. At the time, our fund was at the bottom of the rankings. It was under 60% funded and in the headlines every day. Just getting back on track and getting back into the pack was going to be a victory there.

The problem—and you brought it up from Swensen's book—is what I call the Swensen "J Curve." If you move out on the line of more complex, you don't start immediately seeing returns going up. You start going down. It's only the people at the very end of the curve who do all of it right who are the ones who really succeed.

To add complexity, you add cost. You add a whole bunch of things. And then, as Steve mentioned, you're often likely to have something go wrong—and you're going to have pressure, political pressure to change. I always looked at it as a real return issue. The capital markets on a reasonably diversified 70-30 base of equity and fixed income will likely get you about 3% to 5% real returns over 20 years.

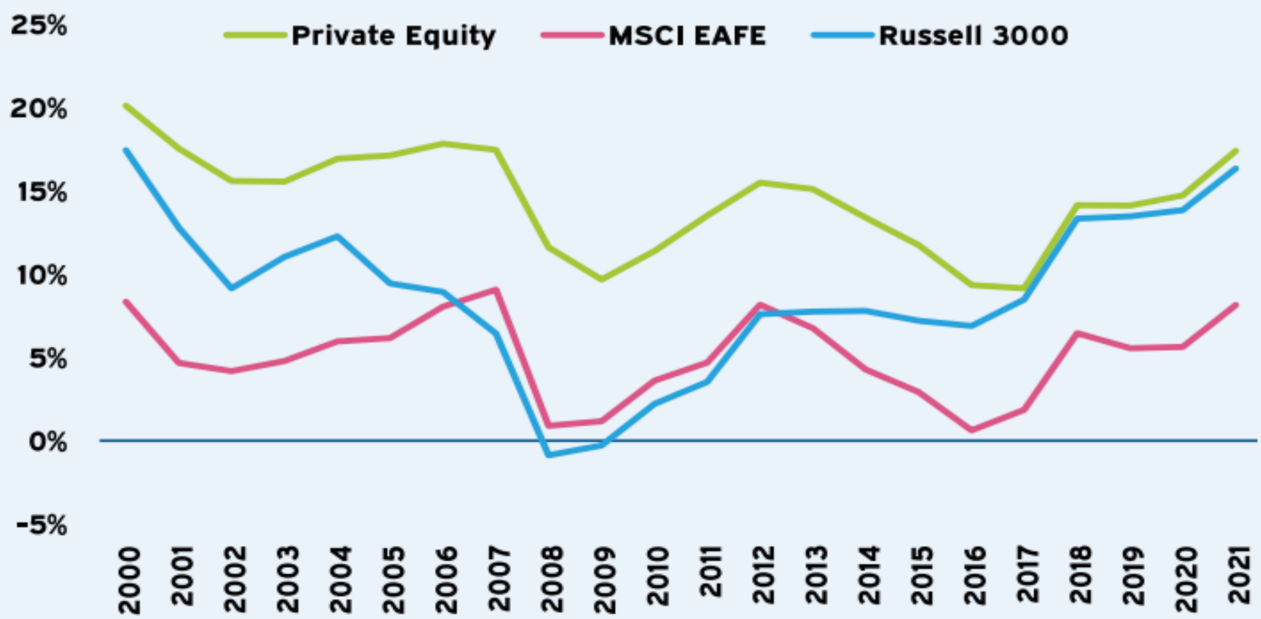
Equity type investments will likely get you 5% to 7% above inflation and bonds may get you 1% to 3%. If you're in that swing zone, there is no compelling need to go to the endowment model. But there are some investors who had 7% to 9% real return requirements. If you're in that class, you either go to the endowment model or you go to Vegas and put it on red. Also, you have to be able to stay the course: my timeframe was 15 to 20 years.

> **"...there are some investors who had 7% to 9% real return requirements. If you're in that class, you either go to the endowment model or you go to vegas and put it on red.**
>
> **Robert Maynard**

[According to Meketa's Private Equity Primer from October 2022: "Historically, private equity investors have earned 2% to 5% per year more than investors in comparable common stocks, even after paying substantial management fees and other costs. Over the last decade, excess private equity returns have shrunk, at least relative to US equities (the margin over foreign equities remains quite wide). Potential reasons behind the decline include increasing valuations of private companies and the influx of capital being invested in the space."[i]]

As shown in Exhibit 2, rolling 10-year returns for private equity have outpaced U.S. and non-U.S. stocks through December 2021.

**EXHIBIT 2 | Rolling, 10-Year Returns* for Private Equity, US Stocks and non-US Stocks**




*rolling, 10-year annual returns as of December 2021.
Source: Data from Meketai, Cambridge Associates via HIS Markit as of August 2022. Indices used: Cambridge PE Composite, Russell 3000 Index and MSCI EAFE Index.

**RS: Does the size of your fund impact the ability to implement the endowment model? My sense is it's more a question of resources and stomach for a long-term approach.**

SM: Well, the reality is that you need to be of a certain size to support the resources to run the model itself. And you have to be of sufficient size to really get access to the underlying strategies in a cost-efficient way and allow for the best outcomes from the model. My crude estimate would be something in the half-billion-dollar range. And then, probably once you hit about $10 billion, it starts getting really tough again because, at that point, scale works against you. You can't allocate to the best managers at the scale that would be required to implement the endowment model. So, there is sort of a sweet spot in terms of size for the endowment model.

**RS: Some people think illiquid markets provide a much greater range of mispriced assets. Is that still true?**

SM: It's probably not that true. It was true 25-30 years ago. There certainly is a little more mispricing potential in the private markets because they're not as liquid. But, today, the reality is companies that trade in the private markets are competitively priced.

The real difference in the private markets relates to the degree of control and influence that owners can have on a company they own. When you're an owner of a public company, you're a passive owner who relies on management to make day-to-day changes to strategy, policy and execution. Private equity managers, or real estate managers, etc., when they buy an asset, they're generally taking more than a 50% stake in that company with a defined strategy in advance, to extract a certain amount of value out of that company in the next 5 to 7 years. So, it's an active strategy that provides, I think, better potential than the public markets.

The other piece I would relate to size. There is a size premium in the marketplace for equities and over time it exists in the public markets and the private markets. To the extent that private companies, based on revenue and EBITDA are smaller, they're going to be somewhat cheaper to buy, and if you buy them at a smaller scale and you grow them over 5 or 7 years, you're more likely going to sell them at a higher multiple. So that's another type of value accretion mechanism in the private markets.

**RS: We got a question as people were registering stating, "We're talking about asset allocation, but this seems to be more a conversation about manager selection. How can you pick a good private or public equity manager?"**

RM: There's a very big "Lake Wobegon" problem here. Everybody is better than average. Being smart, articulate, particularly well resourced, having a successful track record and having good contacts simply gets you in the game. I'm not the dumbest guy around, but I think I'm at least adequate. And I can tell the good from the bad. I can tell the pro from the amateur. But I can't tell the great from the good, particularly in advance. Counting on active management to get you to your goals—because you have to pick the great in order to actually outperform the standard markets—is an errand that should be low on your list of priorities.

SM: There are factors one would look at to identify stronger managers in the public and the private markets—and I think those are well known. They relate to the experience of the team and the repeatability of an investment strategy that they're executing.

The two things I would highlight that are unique to private markets, and I think they're related, is first, there tends to be a statistical degree of serial correlation in performance of different funds. So, with a fund that has superior performance, it tends to mean the subsequent fund has a higher probability of having superior performance. Of course, past performance is not indicative of future results. So, it's not a certainty by a long shot, but the odds are in your favor.

The main reason for that is that there's an art to generating IRR through fund vehicles that private equity managers learn over time. But here, there's another challenge in private markets. Successful funds raise bigger and bigger funds and attract more and more capital. These behemoth asset gatherers are naturally more challenged to deploy capital at scale. So, for an investor, the key is finding that right middle ground.

Second, half of all managers are better than average—and no one can tell the good from the great. Bob's not alone in that. So, typically, the best way to mitigate your specific investment manager risk is diversification—whether public or private markets—across lots of different managers.

RM: I would like to emphasize one thing Steve said. Simply picking a great company early on is by no means enough. You've got to know the business of running a private equity fund all the way through, so on subsequent rounds you don't get diluted, you know how to keep powder dry and do a number of things that are not intuitive.

The other problem is the people you go in with often aren't there after 10 years. You have turnover within the company—and you see that in private equity. You have to hit a sweet spot, and that sweet spot doesn't necessarily last. And the last thing I'd say, I always wanted a public equity manager who had been through a crisis and had come through it. People who have never had a crisis, you can't trust them when the next crisis arises—which may be now.

**RS: Let's talk a little about risk. What approaches would you suggest for forecasting risk and for measuring or managing risk when implementing either approach?**

RM: There is no risk number common across all time periods. Volatility numbers change depending on the period—whether that's daily, weekly, monthly, quarterly, annually, over 3 years, five years, or any period. As a result, there is no basis for having a quantitative risk calculation that applies to the overall fund for all time periods—as you can do for returns—such as risk budgeting, since that number changes dramatically as the time horizon differs. For example, daily annualized volatility of the US stock market is much different than annual volatility.

SM: The standard industry approach is mean-variance optimization. Meketa spends a lot of time evaluating risk from a variety of perspectives. We do this through sophisticated scenario testing and liquidity stress tests. We believe these analyses more fully capture risks in the private market asset classes.

**RS: Taking a step back, how would you define risk? And what about other quantitative risk tools such as Value at Risk or VaR?**

RM: Quickly, risk is when something unexpected occurs. It's when your portfolio reacts differently than what you would predict given market movements—and "the market" has about plus-or-minus 10 factors. If something unexpected occurs, you better be able to isolate it in a few minutes. If you can't, quit.

SM: For us, risk is failing to meet expectations. So, the first and most important element of managing risk is clarifying the expectations, objectives, and requirements of any pool of assets. Quantitative tools can then be applied afterwards.

RM: As for things like VaR, ah! That takes me back! There were big arguments in the mid '90s when it was brought out. Morgan and Bankers Trust, in particular, liked it—and tried to impose it as a standard risk control by auditors. A bunch of us thought it was terribly flawed. I even downloaded the RiskMetrics in Excel in the mid '90s versions. By the way, you guys have it easy these days! I programmed its predictions for my portfolio. [Note: RiskMetrics was "...spun off from JPMorgan Chase in 1998" and acquired by MSCI in 2010.[ii]]

It was horrible. There are a bunch of issues. And that's where I first really started to understand the underlying time period problem. VaR and, then, RiskMetrics was concerned with daily exposure, but I had to have metrics relatable to my yearly issues—not to mention the gaps in the data and the shifting correlation structures. The structures and inter-correlations with the big parts of the portfolios as set out in the VaR and RiskMetrics data were not consistent with the quarterly, yearly, and longer numbers we had. It was hugely different on individual and portfolio wide impacts. Plus, back then, they had no private, real estate, or emerging markets data.

We argued for years. But many investors like "the number" that VaR gives you. They still do. But the "number" is wrong. For example, I can give you a return number, annualize it, and it's good for a day, a month, a year, a decade, or a century. I can scale, and it will be will be equivalent and relevant—whether I use daily returns as the base, monthly returns or yearly. All will agree, no matter the base periods of the data.

You ***cannot*** do that with a risk number. The daily number for volatility cannot be scaled to a monthly or yearly number because the underlying behavior is a different number when you actually use monthly (or other period) numbers. The Ibbotson yearly risk number is ***not*** the daily number. The yearly number is lower. If you use monthly volatility numbers, and scale them, they are very different than scaled daily numbers, and scaled yearly numbers.

I am very suspicious of "risk budgeting" or "risk portfolio rebalancing" or any other quantitative "risk" based approaches. They have not worked. In fact, some of them have been exactly counter-productive by suggesting to rebalance into the most recent, least-volatile behavior or out of the most recent most-volatile behavior—just before those strategies reverse.

And I haven't even gotten into the "tail" risk issue of non-normal distributions. The normal distribution is not the markets, but all quantitative tools eventually default to the random distribution assumptions. None that I have seen have comported to the Complex Adaptive System's math that might apply. So, the risk math works in the normal distribution times—when you don't need it. Then they don't work when you ***do*** need it.

**RS: Switching gears a bit, we got a number of questions about transparency and valuation for private equity. In one question, someone asked about private equity managers who mark prices for assets "...to whatever they want, and then charge outrageous fees on top." How do you guard against that?**

RM: I think it's much less bad than it was in the '90s. It's terrible, I agree, still terrible. But it's less bad. The transparency of the ***public*** markets is the best risk control.

The [lack of transparency] is a reason not to have 30% to 40% of your portfolio in private equity with hundreds of relationships and the difficulty of getting out. Yale, Stanford and Princeton had to issue bonds during 2008 and 2010 simply to meet the requirements to give the money to the university. If I had 30% of my organization's needs depending on my yearly returns, I'd be tight as a tick.

SM: I actually think transparency is pretty good in private equity. That's been our experience for the last couple of decades. It's incumbent upon investors to ask the right questions, and request the right documentation. It's not at all transparent to outsiders who are not investors in the fund. And that's one thing that makes it very different than public equities.

It used to be that private equity valuations were, on average, much more conservative than public equity markets—mostly because general partners never wanted to negatively surprise their limited partners.

That's changed in the industry in the last decade or so, mostly because, for the larger buy-out funds, and larger venture funds, too, management fees are a larger part of the of the revenue they receive. And that has created some misalignment in the activity of some general partners. The valuation issue is certainly an important one.

There have been studies that have shown that there is an upward bias to valuations when some private equity managers are in the process of fundraising. It's not because they want to elevate their management fees. It's because they want to show their fund as top quartile based on unrealized returns when they're marketing the new fund.

If you go into the valuation and performance attribution process, just knowing that there are incentives to mark-up unrealized assets somewhat, you'll do yourself a favor. Generally, in the private equity industry, you get muted marks at the end of the first, second and third quarter. It's at the end of the fourth quarter when you get a real serious review of each of the assets. But even within an audit, there is a range of reasonable valuations, and depending on where the general partner is on their fundraising cycle, they might choose the higher end of that range.

RM: Private equity has not reflected all of the losses last year. But with the numbers I'm seeing right now, there's a lot of downdraft in valuations. Steve, how much longer until we see full valuations? Or will they cushion things a bit on the downside?

SM: It's going to be interesting. The really unique year for private equity was 2021. Historically, private equity would typically underperform public equity when public equities were up a lot. And it would typically outperform public equities when public equities were down a lot. And the main reason is that the valuation processes result in smaller extremes in valuations than you have in public markets.

RM: By the way, that's why I always loved having some private equity. My accountants and auditors and actuaries would recognize that. It may have been a phony happiness, but it made me happy.

SM: (laughing) I agree. In 2021, the public markets were roughly up 30%. And in a year like that, you would expect private equity to be up 15% to 20%. But private equity was up close to 60%. Some of that was crazy crypto stuff in the venture world and growth equity. But a lot of it was traditional buyouts that just had really high marks. Now, it feels to me that there's more of a valuation write-down that's required because of all the write up that happened back in 2021. The question is whether the valuation gap between public and private occurs in the context of public markets going up, and private equity valuations staying the same. Or, are public markets doing what they're doing, and private equity valuations going down a lot more? My best guess at this point is that private equity valuations will go down, but not that significantly—unless we have a hard-landing recession.

Certainly, there are sectors that are more challenged; commercial real estate in the institutional world clearly has to be written down because those valuations are much more tethered to interest rates. With all the private markets having done extraordinarily well relative to public markets in the last year, there's got to be mean reversion. But my guess is that the mean reversion in private equity won't be as severe as some fear.

RS: Steve, you touched on another area where we got a lot of questions—and that's interest rates. With rates having gone up so much last year and still ticking up this year, which approach is better suited in that environment?

SM: Given where real interest rates and valuations are right now, a traditional 60-40 portfolio has more advantages than it's had in a long time. I would still argue the endowment model will likely outperform over time. Right now, a 60-40 portfolio has a long-term expected return of 6% to 6.5%. Two years ago, that would have been closer to 4%.

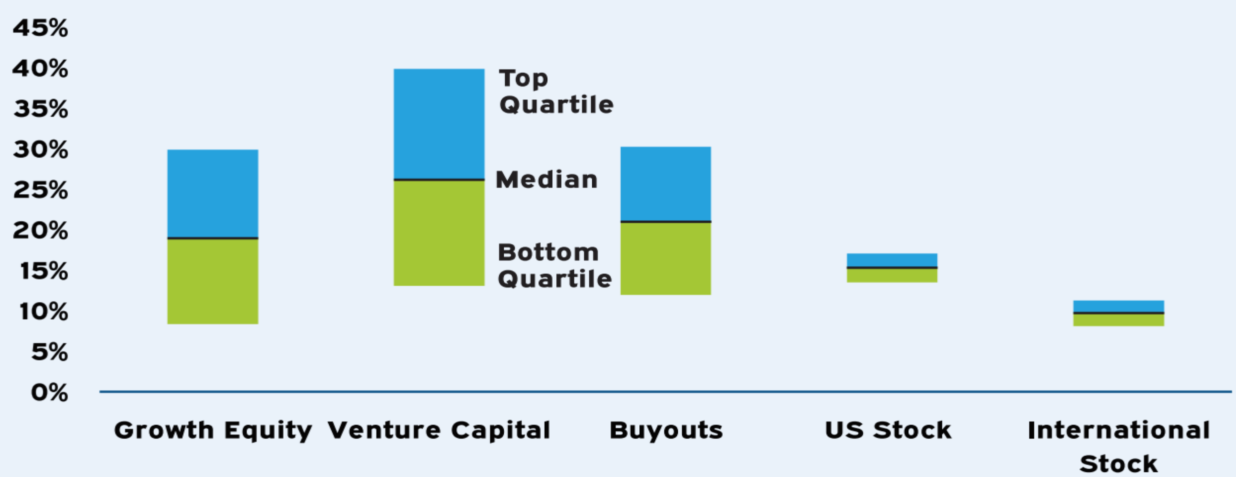
RM: A 60-40 portfolio? You're so 1970s. For most people now, the "traditional" portfolio is 70-30 or 80-20.

SM: (laughs)

RM: You can get the returns up to about 5% real with a "traditional" portfolio. You can't switch in and out of an endowment vs. a 60-40 portfolio. The question is: Is now the time to do an endowment versus a traditional portfolio? And, in my mind, it's neither.

Never fight the Fed. Every time the Fed hits the brakes, someone flies through a windshield. We're still in the middle of that type of process, and so I would hold powder dry for at least another year. It may be over, but to me, this feels like "after" Bear Stearns, but "before" Lehman. I think there's a little way to go, particularly if the Fed continues to raise rates, and I would be reluctant to make a big bet either on the old 70-30 portfolio or on the endowment model for another year or so.

**EXHIBIT 3 | Manager Selection Has Been Vital for Private Equity Firms**




Source: Cambridge Associates via IHS Markit and eVestment. Data for PE funds raised from 2012 through December 2021 and public equity managers for the trailing 10 years, as of December 2021. All data acquired in August 2022.

**RS: So, again, what would be realistic return assumptions going forward?**

SM: Meketa's current estimates for long-term 10-year expected returns for a 60-40 portfolio are about 6% to 7% per year.  For the endowment model, they are generally between 7% to 8% per year. (Meketa's 2023 Capital Market Expectations are included here.) If you look at median historical returns and top- and bottom-quartile managers [see Exhibit 3], you see how important manager selection has been. I think that will continue.

RM: I think Ibbotson data shows a geometric 5%+ annual real return for the US stock market with geometric returns of around 10% with inflation around 3% if I remember the numbers correctly. That is also true of the data that goes back to Civil War times.

**RS: And you expect that to continue?**

RM: Over the longer term? Yes.

**RS: Bob, we got a question for you about how you invested fixed income and what would you recommend today.**

RM: It's bonds for God's sake. Who cares?

RS: (laughs)

RM: Over the long term, we're going to get returns off the equities and fixed income is there as the Armageddon hedge. We didn't look to bonds for the returns; it's basically a safe haven. We had 30% in bonds and that was where we dipped in whenever we wanted to reallocate after equity losses when we had huge volatility. I'd stick with low duration and wait out the next year and a half.

SM: There's a question I see about how the endowment model has performed. Right now, it's not fair. There's a concept called endpoint bias. We're currently at a point where the endowment model historically looks like it outperforms a 70-30 traditional portfolio by 3-5 percentage points compounded over 20 years. But if we looked at that same data 4 or 5 years ago, it would look closer to neutral. My strong suspicion is the endowment model will generally have higher returns over time and have lower risk. Right now, it's not as good as the numbers make it look, but it's still very good.

One other question I find interesting that hasn't gotten more scrutiny is US vs. international stocks. This was highly debated in the '80s and '90s. Everybody kind of went all-in on international and they've done awful for 15 years now. What's your perspective, Bob?

RM: I've always had a US bias. Our liabilities were US-dollar denominated. And the US market is well diversified. You go back long term; it isn't clear to me that international markets necessarily have an advantage—or even an equality—with US markets. It's an interesting question going forward whether international diversification is worthwhile. But then again, you had that problem with emerging markets all the way through the '90s. Then it blew out everything for the next 10 years and then went underground again.

RS: My two cents on this: It's company specific. If you start looking at individual countries, that can take you down the wrong path. But I always think if you have a broad opportunity set, you're going to find some of those mispriced securities that that we touched on earlier. And you give yourself a better chance of doing that if you have a global perspective. Any closing thoughts for each of you?

RM: There are 1,000 right ways to invest. Whether it's the endowment model or the 60-40 traditional model, it really depends on your particular circumstances, liabilities and needs. Steve mentioned earlier that the ability to hold an investment strategy through the inevitable bad times rather than switching is the key. There are a lot of merits to the endowment fund model, but be very careful before you step in.

SM: The keys to successful long-term investing are largely focused on avoiding mistakes—and the biggest mistake an investor can make is adopting a strategy that they or future constituents won't be able to adhere to in future years. Emotionally, investors tend to exit strategies at exactly the wrong time. It's really important to think through whether you or your board members can fully embrace, understand and appreciate the upside and downside of that strategy. If they can't, when that strategy is on the downside, you or your board will flip to the wrong strategy—almost every time.

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[i] Giordano, Lauren, Luke Riela, CFA, Jess Downer, CFA and Frank Benham, CFA, CAIA. Meketa Investment Group. "Private Equity Primer." October 2022. https://meketa.com/wp-content/uploads/2022/10/MEKETA_Private-Equity-Primer.pdf
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