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Conventional Investing vs. the Endowment Model

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Introduction

Recently, members of the Brandes Institute Advisory Board discussed the approach to investing popularized by David Swensen of the Yale Endowment and others in that sector during the mid-1980s, and hence generally known as the Endowment Model. By moving away from a traditional 60% equity-40% bond portfolio and adding exposure to other asset classes such as private equity, hedge funds and venture capital funds, many proponents delivered better absolute and risk-adjusted returns over traditional approaches. However, recent results for this approach have been less compelling. Our discussion focused on whether that approach, with its reliance on alternative asset classes, still makes sense. After a lively debate with diverse opinions, a general conclusion emerged that alternatives are no panacea, but can play a role for investors who use them effectively.
While numerous participants contributed to the discussion, four Advisory Board members dominated the debate (Barclay Douglas, David Iverson, Bob Maynard, and Geoff Warren), and this article is an edited version of their comments.

ROUNDTABLE DISCUSSION LEADERS

BARCLAY DOUGLAS
Founder, Criterium Advisors

DAVID IVERSON
Head of Dynamic Asset Allocation, Accident Compensation Corporation, New Zealand

BOB MAYNARD
CIO, Public Employee Retirement System of Idaho

DR. GEOFF WARREN
Associate Professor at the Australian National University and Fund Convenor of the Student Managed Fund

Barclay Douglas opened the discussion by revealing the top insights he gleaned from interviews with 50 chief investment officers—whether CIOs or OCIOs (outsourced CIOs)—that characterized Endowment Model beliefs and/or approaches:

- maintain a very long time horizon;
- increased equity and equity-like exposure at expense of fixed income;
- seek true diversification;
- rely on manager skill, especially boutiques, those with high conviction and clear vision on capacity limits;
- seek inefficient markets – and a spread between the best and worst performers;
- embrace private investments

He noted that as the debate over the Endowment Model has re-ignited, critics have pointed to underperformance—especially over the last decade or so when the traditional 60-40 portfolio outperformed the vast majority of U.S. public endowments. A handful of stocks drove equity returns in the United States and interest rates plummeted. "That's an unusual period," Douglas said. "A 70-30 or 60-40 mix was really tough to beat. Non-U.S. equities also were a drag on returns. Today, being contrarian is a smart play. The next decade will not look like the last."

With that introduction, the stage had been set for a spirited discussion on why the Endowment Model persists. How can asset owners justify exposure today to hedge funds, private equity and other alternatives?

Maynard: The idea that Endowment Model practitioners have incredibly long term horizons is nonsense. Remember during the Great Financial Crisis (GFC), these funds had to go out for bond issuance. Yale, Harvard, all of them would have been bankrupt—not because they didn't have the assets; they didn't have the assets available. They are not as long term as they think they are.

As for an evolution toward the next stage of investing, there's 100 to 1,000 right ways to invest. The key is picking the one way to invest that is best for your particular situation, who you report to and the liabilities you're trying to fund.

Even Swensen was very clear that the odds are against you. A simple portfolio—the old-fashioned conventional investing—can do very well. What he called the Endowment Model can do better, but only if it's done right. Everybody makes the false assumption that adding a little more complexity will continually give you better returns. It's not linear; it's not incremental. Very few can make it among the ones who go down this path. Recently, some funds have done really well, especially those that loaded up on private equity; it's had a heck of a year. But if you were in hedge funds you probably got crushed.

Douglas: When it comes to pro or con, we'll put you in the con category. Is it because it's never been the right way to invest? Is it structurally flawed? Or is it the investments aren't as attractive as they used to be?

Maynard: For many types of funds, it's the wrong way to go given the nature of their liabilities. If you can handle the short-term volatility, fine. But I think for many funds, it's inappropriate, not to mention the career risk when one of your investments blows up. If you told me you have a real return target of 3.5 to 4%, you don't need to go beyond conventional investing. Some of these endowments have return needs of 7 to 8%. If your real return need is to help keep the organization going, it's either go to a casino or use the Endowment Model. You don't have any choice.

Warren: I'm really struggling with calling it the Endowment Model. When I listened to Barclay describe it, that describes large Canadian pension funds. What we're really talking about is a model that is very active and very willing to take liquidity risk and go into the alternative asset space. We see some of the big Australian super funds moving in that direction. Some of the sovereign wealth funds, too.

Douglas: It's an evolution. Aspects of it have been adopted by every type of fund I know—especially the Canadians, where they tend to be taking things in-house in addition to all of the other Endowment Model attributes.

Maynard: It's been a common tag for at least the last 10 years. The modern trend among investors is often called the Endowment Model; this model places much less reliance on major public market exposures and instead emphasizes intense active management and illiquid vehicles. It often embraces leverage and uses many detailed investment approaches rather than a few. It requires extensive quant models and risk control systems. I don't mind the Endowment Model tag to embrace all this. It's common parlance.

> "Governance is very hard to replicate. You have to get the structure in place to give you the leeway to do what you need to do."
> – David Iverson

Iverson: I don't mind the label; I associate it with David Swensen. He was the forerunner in this space. Alternatives are really the mainstay of these portfolios. They are not very diversifying, but that's always been the case. They currently look very expensive. In the early days, there was a lack of institutionalization; there were rich pickings.

Now, they're pored over and look a lot less like alpha and more like beta. The complexity that comes with these endowment models, I don't think they're that replicable. Folks try to head down this route, but it's very clear that scale is a problem. When I was with NZ Super, it was very hard to get the likes of KKR and bigger players to give us access to potentially superior returns. We just weren't big enough.

There was a study done a long time ago on Yale's portfolio. They found you could replicate Yale's return and risk patterns using US micro caps and value. You can get the bulk of the returns relatively cheaply. It puts the spotlight on the costs involved in replicating the Endowment Model—they are certainly not cheap. And the expected returns have been pared back. The two points I want to stress: these models aren't replicable, and you need large organizations to harvest these sources of returns.

Douglas: I've studied Yale quite a bit. One reason it's hard to replicate is that Swensen was the daVinci of the Endowment Model. He was an early adopter with many managers. He'd seed firms and drive their business. About a decade ago, I was interested in hiring a manager for one of my clients. They had to get approval from Yale because he had seeded them and still approved every contract—every new client they got!

Also, from what I understand, if you took away three of the private equity managers, you eliminated 90% of the excess return Yale generated. It was very superior selection on the private equity side. My last point: governance. Very few investment committees have had such supportive boards and committees.

Iverson: I hadn't appreciated there was such superior manager selection with very few managers actually delivering the alpha. Governance is very hard to replicate. You have to get the structure in place to give you the leeway to do what you need to do. We ran a tilting portfolio and I do something similar now; the key is being able to see your way through a period where there's a massive drawdown. You can look at models, but unless you have the backing of folks to give you the time horizon and capital you need, you can't actually have that portfolio. That's the most un-replicable part.

To harvest these elements, you need the right governance structure. Small funds often don't have the governance bandwidth to operate in this area.

Warren: I totally agree with governance. But to be successful in these models, what do you need? I can highlight five things:

1. Scale.
2. Patient capital. If 35% of your budget depends on generating a return, you don't have patient capital. You can't take the long-term view.
3. Access to attractive assets. This is not so straightforward in alternatives.
4. Access to skill. Skill could be internal or it could be what Swensen had—access to managers. With private equity, it's often an access

game. There's a flood of capital looking for opportunities.

5. The last thing—and this doesn't come with public markets—is the ability to add economic value to your assets. In public markets, if a company is creating value, it's put into the price. In private markets, you can add value and capture it yourself.

That's at the heart of where the value comes from, rather than a reward for illiquidity. You can find an illiquidity premium in public markets as the marginal investor in public markets may value and hence pay for liquidity. People who value liquidity aren't the marginal players in private markets, so it's not necessarily priced.

Maynard: I'd add a sixth—luck. You gotta have some luck.

Douglas: There's something called the NACUBO [National Association of College and University Business Officers] smile which means the smallest funds have good returns; the largest funds have good returns and those medium-sized funds who are playing in games where they don't play very well—they have the poorest returns.

Geoff, I agree with all your points, especially the last one. But can you elaborate on scale? To me, the only thing scale brings is access. There are small funds with luminaries on their investment committees; they have access and they've done well.

Warren: If you play the property or infrastructure game, you need scale. You need scale not only due to the size of the assets, but also because you can't do it by yourself. You have to collaborate. When it comes to other assets, you can still be a player, but you need an internal team for a start. If you don't have scale, you're not going to have an internal team. Once you get scale, it interacts with the governance side, as well.

Iverson: Scale leads to internalization. We're not touching on this. Maybe it's the difference between married and dating. Canadian pension plans are married; they're committed. You're talking about a commitment to investing in resources whether you have expertise internally or externally; that's the commitment piece. And that's what I mean by scale rather than size, as well.

DR. GEOFF WARREN: FIVE ESSENTIALS FOR SUCCESS

1. Scale.
2. Patient capital.
3. Access to attractive assets.
4. Access to skill.
5. Ability to add economic value to your assets.

Maynard: Some can put money in just a few venture capital funds and it really moves the needle on returns. The returns Barclay talked about—those are where they can be in funds that had tremendous years and it drives overall returns while that same fund in my portfolio wouldn't move the needle. I couldn't put enough in it to make a difference.

Iverson: Part of that [NACUBO] smile is that with smaller funds, you can move the needle. The larger funds need much greater infrastructure and access to replicate that alpha source. The folks in the middle? That's the worst place to be. You want to play the game, but you're not committed and you're not big enough to be able to have the sources of returns to make a meaningful impact.

Douglas: There's a lot of money squandered in chasing the Endowment Model. Every single one of the CIO interviews I did agreed with one point: if you can't execute the Endowment Model, don't do it. The problem? Everybody thinks they're above average.

Iverson: Active managers think they're above average.

Maynard: Well, you don't want to hire managers who don't think they're above average. You're depending on getting better-than-average active managers; you've got to get in the top third. And you have to pick them in advance. One problem I've had is I can pick a pro from an amateur, the good from the bad, but I can't pick the great from the good. With everybody I talk to, the managers are smarter than I am, so how can I pick great from good?

> "Implementing [the Endowment] Model with an investment committee advised by an asset consulting firm and picking up whatever they can get access to… no wonder it fails."
> – Dr. Geoff Warren

Warren: I am surprised by how small most US endowment funds are according to the NACUBO data. You've got a few behemoths at the top. Implementing this model with an investment committee advised by an asset consulting firm and picking up whatever they can get access to… no wonder it fails. In most cases, you don't have the scale and governance structure to make it work.

Douglas: This is one reason why the OCIO industry is growing so dramatically in the US. The problem is all-in fees with OCIOs are very high. They may be insurmountable. I don't think there's a non-profit below $500 million that hasn't outsourced—or isn't considering it. Ten percent of endowments may keep management in-house, but outsourcing is a major trend in the US.

Maynard: There is a list of specific questions that go into the discussion. For starters, do you want to reduce your reliance on public markets? Two, do you want to reduce your reliance on fixed income as your Armageddon hedge? If the answer is yes, then the question becomes, do you want to do more active management, go into things that have scale issues, and so on? Isolating those types of questions and the pros and cons is worthwhile.

Iverson: You have to ask those questions in conjunction with the reality that you don't get passive private equity. You don't get passive alts. None of this stuff is passive. Then, you're back to the same old active/passive discussion. It's a zero-sum game of course, but you just can't see that. You don't have the benchmark version—what's the passive version of some of these assets?

Maynard: That's an advantage from the staff position. You can make the benchmarks and get your returns and bonuses.

Iverson: So invest heavily in this stuff and line your pockets? Get paid more and hide the valuations. Just smooth them out. It's brilliant!

Douglas: I have to step in. I do agree that the internal benchmarks have been easier to beat over the last decade and the reason is funds that go into hedge funds and private equity and real assets will set their policy allocation benchmarks based on those exposures. I would be willing to bet that over the next decade, there might be a flip. That traditional 65-35 or 70-30 benchmark may be the one that is easier to beat than the internal benchmark. I don't want everybody to think the public funds and endowments creating internal benchmarks are dishonest. They all want to do well, but I think there could be a flip.

Maynard: There is another benchmark problem and you see this with complex portfolios. They may have 10-15 for the overall portfolio. But they can have hundreds of internal benchmarks for each of the individual portions. And you can't match up the top-down and the bottom-up benchmarks. So that's another benchmark problem—making sure they are consistent and trackable all the way to the bottom.

Iverson: This reminds me of one of the things I used to do. We would fund every new investment out of a simple bond/equity portfolio. That means the cost of funding is the bonds and the equities. Everything had a beta match back to it. This is not easy to do. But then you'd have a performance benchmark that was your cost of funding plus the alpha you expected to make on top. You'd tie them together. If you don't do that, you can get this massive benchmark mismatch where you can pay for underperformance.

Maynard: You were doing it right.

Warren: Setting up the reference portfolio was the foundation for that.

Maynard: That was the basic problem with whether hedge funds did what they were supposed to do after the GFC. If you were a fund that took the money from equities and put it into hedge funds, hedge funds were great. But the problem was everybody believed in equity-like returns with bond-like volatility and they funded their hedge funds from the bond portfolio. They were losing 19% when bonds were up 6%--and that killed them. It took some of these plans six years to recover.

Iverson: It was the idea of market neutrality if you were going for that with hedge funds; they were not market neutral during the GFC. They had large equity betas; we experienced the same.

Douglas: Hedge fund assets have been growing recently but those who have been long-term investors have cut their allocations. Why? Is it belief in a structural flaw, or too many people in that space and alpha is gone? I'd say 80% see a structural flaw. The fees were too high of a wall to climb. It's a tougher game now. And with interest rates where they are, hedge funds are very challenged.

Maynard: Many people went into hedge funds because they wanted better short-term returns in times of volatility. That's why they paid higher fees. But many of these strategies require long-term horizons. The idea that you could trade in and trade out—it's tough to provide those consistent returns. People have not been pleased with the inconsistent returns.

Douglas: People point to alternatives and, not just the ability to outperform, but the persistence of outperformance. Many people have suggested, just as they have with long only equity, there's no persistence. But private equity is different. To some extent, when you build a strong enough name, you get better deal flow. That's one reason for persistence. But given the size of some of these partnerships and the multiples now that are in the marketplace, I don't know if that will continue.

Maynard: It's been one of the biggest surprises to me since the '80s and '90s—the ability of private equity over time to outperform public markets. They haven't done it against the Russell 3000 Index or the S&P 500 Index, but they have against global equity benchmarks. That's an extremely interesting question now that people are piling into it more. Last year, the average private equity fund had a great year and that really helped smaller endowments with good private equity investments.

Iverson: Is that leverage adjusted? They've had a massive tailwind. There's been a wave of very low

interest rates and huge liquidity going in. It benefits good and bad companies. When that turns, there might be a greater dispersion among those private equity managers.

Maynard: Well, I'm going to keep with what we've always done—the conventional approach. Some private equity and real estate, but mostly public market equities. 80% public and 20% private or illiquids. Every decade, people have said it will be a terrible decade. They said that two years ago. Then Covid hit. I've got to see the whites of the eyes of a real disaster for 2-3 years before I make any major switch on any long-term strategy.

We still believe in active managers. We want swing-for-the-fences managers. I don't like them hitting business risk before they hit portfolio risk. I'm not happy if they want to diversify to protect their business. I like managers that are willing to be more volatile with returns.

Russell 3000 Index: The Russell 3000 Index with gross dividends measures the performance of the largest 3,000 U.S. companies. **S&P 500 Index**: The S&P 500 Index with gross dividends measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

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