

## **ENDOWMENT MANAGEMENT: AN INVESTMENT ADVISER'S PERSPECTIVE<sup>1</sup>**

### Introduction

The endowment fiduciary's primary task, in my judgment, is the establishment of a charitable corporation's total financial policy insofar as it relates to the endowment. So, my first goal will be to set forth a personal catechism for how I believe fiduciaries should discharge their responsibility in this regard. Second, I will attempt to provide a *tour d'horizon* of the capital markets in terms of the available and accepted investment media through which that financial policy should be executed.

#### I. Financial Policy<sup>2</sup>

An endowment's financial policy is essentially a set of internal imperatives (external imperatives, in the form of "legal lists" or donative restrictions, for example, may impact as well).<sup>3</sup> Two are static in nature, in the sense that they do not require frequent review and modification. The first of these is the determination of what I would call an endowed institution's terminal goal—its expected life. The range of choices runs from perpetuity to, I suppose, "as long as the money lasts." For most, the answer is self-evident—perpetuity—but if that is the choice, it is very important that the implications for financial policy—essentially those of forbearance and discipline—be kept firmly in view, for perpetuity is a demanding goal. Indeed, in my own experience, I have watched a large endowment lose more than three-quarters of its net asset value as a result of overspending during a period of poor performance in the capital markets, yet all the while it maintained an explicit policy of an "aspiration to perpetuity." The contradiction at least raises a presumption of imprudence, in my view.

A second static issue is the creation of an appropriate structure for the management of an endowment. Fundamentally, this is a question of delegation (and accountability)—where will operational responsibility be lodged? A range of choices presents itself: the full board or a subcommittee may retain authority for the investment of the endowment, initiating or at least approving every transaction, or more likely it may delegate the

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<sup>1</sup> Based on remarks given before the Association of the Bar of the City of New York, Committee on Non-profit Organizations, on October 3, 1991.

<sup>2</sup> However a given endowment resolves the various issues discussed in this essay, it is imperative that the results be embodied in a formal, written record. This document is generally known as an "investment policy statement" and bears periodic revisit and occasional revision for any endowment.

<sup>3</sup> While this essay does not address the legal context affecting endowments as they construct and implement overall financial policy, it should be noted that most states have enacted two so-called uniform acts (one for endowments organized as corporations and the other for those as trusts) that are directly applicable. Each contain a version of the ancient "prudent man rule," and both have fairly specific prescriptions and proscriptions about investment policy. Private foundations are also subject to certain provisions of the Internal Revenue Code that speak to these matters. Every endowment, large or small, should consult with counsel to determine its precise legal context.

authority to an appropriate officer such as the corporate treasurer. For most endowments, it will likely prove expeditious to convey discretionary investment authority to one or more independent organizations—banks, insurance companies or counseling firms. Finally, at the extreme, some large institutions have built professional operations to manage their endowment assets, largely to take advantage of the economies of scale, and a few, like Harvard, have even organized them in separate subsidiaries in order to insulate them from personnel (read: compensation) and other administrative policies in the “parent” institution.

Now let’s turn to two dynamic issues that form the rest of the issue of financial policy. These are matters that require periodic review and readjustment, generally at the level of the full board or a subcommittee, at least annually.

The first of these is spending policy—that is, what percentage of the endowment will be spent annually on operations (administration, charitable purposes, etc.). Obvious factors affecting spending policy will include the amount and variability of other operating revenues (e.g., membership dues, research contracts, tuition payments, publication sales, etc.), the level and variability of expenditures (such as the perceived urgency of charitable purposes or the recognition of new ones), the institution’s terminal goal (i.e., the more distant the goal, the more conservative the spending policy) and, in the case of private foundations, the minimum expenditure requirements embodied in the Internal Revenue Code, presently set at 5% of asset value. Ideally, spending policy will be expressed in the form of a so-called spending rule (i.e., a relatively formulaic or mechanistic expression), for two reasons. On the one hand, the power of the computer enables us to model outcomes (“simulations”) with remarkable subtlety and accuracy, which gives greater credibility to mathematical results. On the other hand, endowments are, in the vernacular, the world’s greatest honey pots and tend to find themselves surrounded by voracious bears (deans, program officers, grantees, etc.) all determined to dip a paw. An inflexible spending rule, as opposed to a vague policy, may be the best deterrent.

Spending rules come in various forms. One, fairly arbitrary version allows the expenditure of a fixed percentage of assets, a level determined by the institution’s terminal goal and its trustees’ view of the long-term relative risk and expected return of relevant asset classes. Another, more sophisticated version uses current forecasts of the same matters, including inflation, to fashion a more variable level of spending—one that might, for example, result in a different percentage of assets budgeted every year. A third methodology that has some intellectual appeal is based on payout levels for the stock market (dividends divided by price for the S&P 500, for example) since dividends historically have (for obvious reasons) tended to track real corporate growth, ultimately the engine that sustains the purchasing power of most endowments. A reasonable application of such a spending rule for a given endowment would be that total expenditures would equal 125% of the dividend yield on the S&P 500 times the endowment’s aggregate market value. Finally, whichever means of determining the annual percentage is used, it is then multiplied by a base typically derived from an average of aggregate asset values over a small number of years—a so-called smoothing rule.

The second dynamic issue of financial policy—investment policy—flows directly from spending policy, although in an interactive or dialectical fashion. That is, assuming

a terminal goal of perpetuity, the more liberal an endowment's spending policy (i.e., the more aggressive or risk-oriented), its investment policy must be. The three policies, in other words, must be mutually consistent. The absence of such harmony will necessarily jeopardize a given endowment's ability to meet both current and future obligations—its charitable purposes—and therefore, in my view, constitute presumptive imprudence.

For most endowments, investment policy is expressed principally in terms of asset allocation, which is largely a matter of three major asset classes—equities, fixed-income and “cash.” Typically, an endowment's board will (from time to time or “permanently”) establish ranges for each class in terms of percentages of total assets with which those to whom it delegates investment responsibility may operate. (An endowment employing multiple outside investment managers will generally implement asset allocation by managing the aggregate sizes of the accounts of those managers with specialized responsibility for the respective asset classes by adding to or withdrawing from their mandates over time.) In addition, a given endowment may elect to pursue other, less conventional asset classes (some of which will be discussed later) in order either (i) to add risk (in the technical sense of variability of returns or volatility) and therefore increase expected returns on the margin or (ii) to provide greater diversification and therefore lower risk without reducing expected return (a notion also discussed more fully later on). Investment policy may also involve such ancillary matters as brokerage, ethical concerns, etc.

The roles of the three major asset classes can be described succinctly. Equities are the principal mechanism by which risk—strictly in the technical sense defined above—is undertaken in order to maximize expected returns over time. (Other, less attractive means of doing so include leverage—borrowing—and short-selling.) As a theoretical matter, diversified portfolios of equities must achieve higher total returns over time than fixed-income portfolios, and as an empirical matter, over broad reaches to time—say, decades—they have done so.

Let me amplify slightly the theoretical proposition. First, according to both instinct and the academic school of thought known as Portfolio Theory (in particular, what is known as “mean-variance” analysis), investors demand higher expected returns (i.e., a lower initial cost or price) *ex ante* for higher risk investments (i.e., those with greater volatility or variability of returns). Among publicly traded assets (equities, bonds and money market instruments), equities are, in this sense, inherently riskier—after all, common stockholders are residual claimants on a corporation's assets and revenues—and therefore should receive higher total returns *ex post*. Second, Portfolio Theory's so-called Capital Asset Pricing Model (“CAPM”) reinforces what instinct also tells us: diversification pays. In essence, the risk (measured in terms of standard deviation) of a portfolio of equities or other securities will be less than the weighted average of each security's risk. Therefore, to paraphrase the old saw about real estate, the first three rules of investing are diversification, diversification and diversification. Practically speaking, CAPM and experience show that a portfolio with fewer than 40 to 50 securities is probably underdiversified.

As to the empirical superiority of equities, the best data demonstrate that equities on average produce real (i.e., after inflation) rates of total return (dividends plus appreciation) of around six to seven percent per annum while bonds achieve only about one to two percent (interest plus appreciation, which over longer periods of time—long

enough to incorporate a complete bond market cycle—will be zero). Obviously, the spread between the two rates of return compounded through time—what one sage observer has called the Archimedes’ lever of investing—supplies the power to sustain any endowment that otherwise must contribute materially if not exclusively to the accomplishment of a charitable institution’s mission. As a result, endowments must be equity-oriented if they are to support operations and sustain purchasing power.

Why, then, any fixed-income assets at all? The answer lies in the ability of bonds to dampen total fund volatility (again, the variability of its total returns) at an acceptable cost of lower expected returns (i.e., the spread described above). In theoretical terms, CAPM tells us to use bonds (as well as other asset categories) to eliminate so-called diversifiable or “residual” risk and thereby achieve the most efficient portfolio. Put more in laymen’s terms, for many endowments, like any pension plan making current payments to retirees, such balance permits more orderly financial planning and may, depending on the kind of kind of spending rule the institution employs, allow a higher level of spending than would be prudent for an all-equity endowment. In other words, even if an endowment’s terminal goal is perpetuity, its horizon is not completely long-term because it must spend in the short run. And please note that the foregoing ignores the hoary and by now completely discredited distinction between income and principal enshrined in private trust law.

As an asset class, cash (i.e., very short-term or money market instruments) plays two roles. The first is residual: on the one hand, it represents part of the friction costs of investing and trading—interest and maturity payments dividends are seldom paid in kind, and there are few barter mechanisms in the equity and bond markets. On the one hand, like any organization an endowment must obviously manage its operating cash to make it as productive as possible, after receipt or before disbursement (idle cash is the Devil’s tool, so to speak). Second, cash is the neutral corner of choice for those institutions that attempt to time the equity market—that is, to reduce their equity position from its normal level at perceived points of market overvaluation and the converse when equity markets are undervalued. There is a lively, ongoing debate among academics and investment professionals alike about the utility of market timing, but it remains a very widespread practice.

Finally, I will not bother to discuss individual security selection or trading. The reason is that its contribution to investment results is secondary: asset allocation accounts for perhaps 90% of relative success or failure in achieving investment goals and, to a somewhat lesser extent, even that for its equity component (where the term applies to sector and industry distribution). Stock picking, in other words, is a distant also-ran in the performance derby, contrary to most individuals’ instincts and assumptions.

## II. Capital Markets

### A. Conventional Asset Classes

The foregoing functional analysis of the principal asset classes leads logically to a summary description of the respective capital markets. In the absence of state or regulatory “legal lists” or donative restrictions, this is the terrain within which investment policy largely must operate. Other, more marginal asset classes are treated below.

The U.S. equity market is the world's largest in terms of aggregate market capitalization. Moreover, it is the most efficient and most transparent (in the sense that posted prices are real) in the world. As a result, endowments in the U.S. have the good fortune, not always appreciated, of having the means at their disposal to support significant spending, even in the absence of other sources of operating income, and yet to sustain purchasing power through time.

Fixed-income markets in the U.S. are enormously deep and wide. They are deep simply because of the voracious appetite for debt demonstrated by domestic borrowers—public (government) and private (corporate and individual)—over the last several decades. They are wide because, first, the range of traded, institutional fixed-income securities has been greatly extended, as exemplified by the extraordinary (and largely beneficial) phenomenon of “junk” bonds, and, second, assisted by the power of the computer, Wall Street has been able to assemble separate obligations and repackage them for institutional consumption, as represented by the tremendous growth and range of mortgage- (or other asset-)backed instruments and other exotica.

Some might dispute the proposition, but there is a strong argument that another major (or conventional) asset class is foreign equities. Theoretically the case is truly indisputable that foreign equities provide superior diversification (and therefore lower volatility) at no cost to expected return. Foreign equities are the proverbial free lunch in theoretical terms, and by now they have certainly become a familiar portfolio component for most larger, sophisticated endowments. There is no structural reason that they should not be virtually universal. The only caveat is that it is basically impossible for an endowment (or any other institutional investor) itself to manage a portfolio of international equities, or at least it is most unwise to attempt to do so. The task is much better left to an outside specialist money manager.

Cash is obviously a major asset category, but given its transactional and residual function, there is no reason to treat it at length here. It is, in that respect, more tactical than strategic.

## B. Unconventional Asset Classes

For larger and more adventuresome endowments, there are a number of outriding asset classes to consider. The most obvious is equity real estate, which offers a high reward potential at the cost of significant illiquidity, major management intensiveness and generally high risk (i.e., both the variability of returns and the difficulty of diversification). Still, on balance it can represent an attractive strategy on the margin.

Derivatives represent a very different set of alternatives. They can be used very conservatively, even defensively, as a hedging device or they can implement relatively high risk (and very sophisticated) trading strategies. These run from writing covered call options to running matched-book positions.

Finally, there are various species of investment strategies that can be found on the fringes of the capital markets. They are usually organized as limited partnerships, and generically their popular names are venture capital, private equity and hedge funds. Strictly speaking, they do not constitute separate asset classes but simply are sophisticated ways of extracting extra value using conventional kinds of securities, equity or fixed-income. In any event, though darlings of the financial press (and even the

popular press occasionally), they generally are inappropriate for all but the largest endowments, not least for the serious illiquidity that they virtually always involve. To put it another way, if a small endowment is offered the opportunity to participate in any such fund, it should be highly skeptical about the quality of the fund's management and the effectiveness of its strategy. In other words, if you can buy it, you do not want to own it.

### C. Other Approaches

Endowments must also consider other ways of achieving their asset allocation objectives, depending on their circumstances. Unlike pension plans, however, insurance-based approaches offer no promise because in general endowments have no long-term liabilities and therefore no actuarial reason to pay for this means of balancing (or form of intermediation between) asset and liability.

For small endowments, mutual funds bring a very sensible way of achieving all of liquidity, diversification and professional management. There really is no better way to put “non-institutional” money to work—the principal reason, I might add, that my own firms uses mutual funds as the sole means for managing clients assets.

At the other end of the spectrum lies passive management or indexation. Large pension funds (which are many times the size of large endowments) have increasingly recognized that in various respects they are the market. Therefore, many have elected simply to “buy” the market by allocating most if not all of their equity assets to index funds. Whether or not a large pension fund's fiduciaries subscribe to the so-called Efficient Market Hypothesis<sup>4</sup> and therefore no longer believe it possible to “beat the market,” transaction costs, which go well beyond commissions, alone make this choice compelling if not imperative. Few endowments suffer from this compulsion, but some have elected to pursue indexation.

### III. Conclusion

Finally, two points not necessarily inherent in the foregoing bear emphatic mention. First, in managing endowments, conservatism in the traditional sense may be the most dangerous and, indeed, imprudent course. The reason, of course, is that it tends

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<sup>4</sup> The Efficient Market Hypothesis (the “EMH”) states that assuming normally functioning markets, security prices at any given time reflect all known information and thus are, in colloquial terms, fair and accurate. It assumes or implies that investors are rational economic beings. Portfolio Theory in general and its corollary (or predicate), the EMH, in particular have become the prevailing orthodoxy over the last 30 years or so after successfully challenging more conventional, “practice”- based thinking about the capital markets, but recently they have witnessed the arrival of a new heterodoxy called behavioral finance. If Portfolio Theory sprang from the academic field of statistics, behavioral finance comes from the school of social psychology. To explore behavioral finance in this essay would take us too far afield, but suffice it to say that its theorists and practitioners say that security prices simply are and never represent some pure standard of accuracy or fairness. To them value is in the eye of the beholder, and since that beholder is generally human and therefore fundamentally irrational, security prices will only coincidentally and occasionally represent “fair value.” They point to all of the manias of the last 300 years—from tulips to tech stocks—and say simply, QED. Today, many larger endowments implicitly embrace behavioral finance especially in their use of private equity and hedge funds since both presume that securities are systematically mispriced.

to lead to the absorption of tremendous opportunity cost and, ultimately, not to “conserve” at all. It sacrifices the interests of future generations (the remaindermen of private trust law) to those of the present without admitting it.

Second, the essence of endowment preservation is found not in legal lists, categorical restrictions or other rigid proscriptions and prescriptions. Not only do these crude approaches inevitably trail the pace of innovation in the capital markets, but they force the focus on the wrong end of the problem: they look at individual securities or security types rather than at portfolios. Instead, prudence more generally lies in the process, in two senses. First, it means that, defensively, endowment fiduciaries can best protect themselves by considering carefully (and documenting those considerations) what strategies they chose for the management of an endowment. More fundamentally, however, these fiduciaries will best fulfill their responsibilities through continuous interaction with both the up-to-date developments in the capital markets and the cutting edge of theoretical (mostly academic) advance. In this respect, endowments cannot afford to wait or to lag; they must lead. Historically, it is fair to say, in contrast to their institutional brethren—pension funds, insurance companies, etc.—many have done so.

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