Endowment model

How non-profits can improve upon the endowment model—and make it work for them

Russell Investments Research / Viewpoint

Mary Beth Lato, CFA, Director, Investment Strategy & Solutions

The endowment model has been celebrated, maligned and examined intensely over the past four decades. Popularized by Yale University, the model is often characterized by a low allocation to core fixed income and high allocations to hedge funds and private capital. However, there's more to the model than that. The foundational principles of the endowment model are thought to include leveraging investment expertise and a long-term perspective to add value by dynamically managing the portfolio through market dislocations and investing in more complex and less competitive areas of the market. This results in an investment philosophy that aims for higher returns and places a greater emphasis on skill and the illiquidity premium than you would see from a typical institutional investor. It also implicitly requires organizations to have large investment staffs with the ability to manage complex portfolios, the resources to identify and access top managers at attractive fee levels, a financial plan that allows for high levels of illiquidity and a flexible governance structure.

Recent experience and outlook of the endowment model

Many organizations without the aforementioned resources have tried, and to some degree failed, to replicate Yale's success, which has fueled much of the conversation about whether the endowment model is "dead" or "broken." We believe this perceived failure is due not to the underlying principles of the model, but rather to its sub-optimal implementation. We have seen others try to mimic Yale's approach by significantly increasing their allocation to illiquid investments, such as hedge funds and private capital, without the same access to top managers or the scale to properly diversify their exposures, or without maximizing return opportunities in other areas of their portfolio. This lack of efficient implementation has led to sub-optimal results. And even for institutions that have had success with the endowment model, increasing implementation efficiency may help further enhance returns over the long term.

To cast additional doubt on the soundness of the endowment model, not only have some small-to-medium sized institutions encountered problems in implementing the model; in fact, the institutions that did *not* attempt to mimic the endowment model have generally been very successful. The best performing asset class over the last decade has been U.S. equity. Therefore, a portfolio with a concentrated exposure to U.S. equity and an allocation to U.S. core fixed income for risk reduction would have outperformed most portfolios that looked to diversify across growth assets for total portfolio risk reduction. Because diversifying asset classes such as marketable real assets, hedge funds, non-U.S. equity and return-seeking fixed income have all underperformed U.S. equity over the last 10 years, the inclusion of these asset classes, while moving from a simple domestic equity- and bond-focused portfolio to the endowment model, would have hurt returns over the last decade. We want to emphasize that while this was true for the past 10 years, we do not believe it will necessarily hold true for the next 10 years. In fact, current low U.S. government bond yields and high U.S. equity valuations mean that building a diversified portfolio will be even more important on a forward-looking basis.

Maximizing returns from all aspects of your investment portfolio is one of the keys to enhancing the endowment model

We believe every investment portfolio should have the following five elements to drive returns in a risk-aware manner.

1. Diversified market beta

A portfolio with diversified market beta moves beyond a simple allocation to domestic-biased listed equity and core fixed income by globally diversifying and introducing strategic exposures to real assets and return-seeking credit. By diversifying the strategic return sources, the portfolio is expected to better withstand market stresses while generating the same level of long-term growth.

2. Illiquidity premia

Illiquidity premia are the returns you receive for allocating capital to assets that are less liquid and are susceptible to large price changes if they are sold before they mature.

3. Specialized alpha sources

Specialized alpha sources seek to generate excess returns through security selection and strategies that are uncorrelated to market risk. This is achieved through access to superior managers, along with understanding which markets they are anticipated to perform best in and adjusting the allocations accordingly.

4. Alternative risk premia

Alternative risk premia (i.e., factor exposures) lead to long-term excess returns as a reward for the investor assuming a systematic risk. These premia include such factors as size within equity markets, credit within fixed income markets and carry within currency markets.

5. Dynamic management

Dynamic management ties the portfolio together by altering exposures to broad market betas, regions, sub-sectors, managers and/or factors over time. Dynamic management allows you to generate returns by over-weighting areas due for outperformance, and under-weighting areas that are thought to be risky and likely candidates for drawdowns or sluggish returns.

The extent to which each return source can add value depends on the risk you are willing to allocate to it.

Incorporating these elements into your strategic asset allocation (SAA), portfolio construction and implementation efforts will help ensure that no return source is overlooked, which is critical to long-term success. These elements are often connected, as an allocation to private capital is likely to include diversified market betas, illiquidity premia, specialized alpha sources and alternative risk premia. The extent to which each return source can add value depends on the risk you are willing to allocate to it.

Ensuring your SAA, portfolio construction and dynamic portfolio management efforts are efficiently implemented will help you maximize returns

Your SAA contributes 80% to 90% of the variability of returns and serves as a guide for your investment program. The decisions you make at this strategic level will drive the efficiency with which your investment program can be implemented, as well as whether you'll be able to maximize the return potential of your entire investment portfolio. There are three key strategic decisions that drive your SAA.

1. Spending policy and desire for perpetuity

For better or worse, your spending policy and desire for perpetuity are closely intertwined. Your spending policy outlines the total level of expected annual spending and the extent to which the spending is fixed or that it immediately reacts to changes in asset values. Your spending level, combined with your organization's desire for the assets to maintain themselves in perpetuity, defines your return target. For example, if your endowment desires to maintain the real value of your assets in perpetuity, the appropriate return target would be your rate of spending plus expenses plus inflation.

2. Risk tolerance

Risk tolerance is the amount of risk your organization (and investment committee) is comfortable taking on to pursue the returns you need, while still being able to sleep at night. This tolerance level is unique to each organization and will directly drive the diversified market beta you choose to incorporate into your SAA and, ultimately, into your investment portfolio.[1] For example, if you have a fixed, inflexible spending commitment that you need to meet each year, you are going to make very different decisions about risk than if your spending needs were flexible.

3. Liquidity needs

As mentioned earlier, one of the hallmarks of the endowment model is a significant allocation to illiquid assets. Prior to investing in private markets, it is important to properly analyze the level of illiquidity your portfolio can undertake and how the illiquidity of the portfolio might increase in stressed environments.

Keep in mind that for organizations that cannot tolerate illiquidity, an over-allocation to illiquid investments in stressed environments can create both realized and opportunity costs. During the global financial crisis, some organizations experienced liquidity stresses due to private capital portfolios that became cumbersome to manage and hindered the flexibility of their total portfolio as well as their ability to meet their spending goals. This is why properly analyzing your organization's liquidity needs and scaling your illiquid investments accordingly is so critical. Not doing so can generate consequences that negatively spill over into other aspects of the portfolio, as well as the total portfolio.

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Portfolio construction—bringing your SAA to life

Designing your SAA is critical; however, in the current market environment, it may not be enough to generate the returns that many endowments and foundations desire. One of the additional implementation decisions you'll need to make is the type of active manager alpha and alternative risk premia you should incorporate into the investment portfolio.

One of our portfolio construction beliefs is to only take risks that you believe you will be compensated for taking. Another belief is to focus the fee budget on areas that you believe will deliver the greatest alpha. By identifying alternative risk premia and layering those excess returns over low fee beta sources, you can then focus your fee budget on managers that aggressively pursue excess returns through security selection. The pairing of factor exposures and concentrated active portfolios creates a balance among return sources, tracking error risk and total costs.

Dynamic portfolio management

Dynamic portfolio management, if executed skillfully, is expected to improve the endowment model. It's a strategic decision as well as an implementation decision. The decision about whether or not to manage your portfolio dynamically should be made during the SAA stage, as it will drive the types of opportunities you ultimately choose to incorporate into the investment portfolio. Dynamic management allows investors to diversify the return sources in their portfolio and increases the likelihood of being able to capitalize on market opportunities. It may also mitigate drawdown risk by positioning the portfolio away from weak or over-valued asset classes.

As an example, if an opportunity arises within bank loans just as high-yield debt becomes less attractive, with a dynamic management structure in place, the SAA does not need to be re-visited before capitalizing on that opportunity. When a consciously designed dynamic management framework is deployed, there is less concern that dynamic shifts might derail the portfolio and prevent it from reaching its long-term goals.

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Constructing the private capital allocation

The other aspect of the endowment model that is difficult for smaller organizations to create on their own but is critical to success is the private capital portfolio. Smaller organizations often have four hurdles in building a robust private capital portfolio: access, alignment, advocacy and administrative support. Access to superior opportunities and managers in this space is key to efficient implementation, as well as enhancing return potential in your portfolio. That access is often restricted to investors that have a history and relationship with the manager—and many smaller endowments may lack this. In addition, the due diligence, from an investment and an operational perspective will have a big impact on the outcome, and many small organizations do not have the internal resources to perform these functions. Alignment of private market exposures to the rest of the portfolio is also critical. Risk management within the private capital allocation will occur through diversification across managers, strategies and vintage years. This requires many allocations at small percentage weights. Due to minimum investment sizes, a smaller organization will likely need to allocate larger percentages to individual managers and strategies as they don't have the scale to achieve minimum investment levels across a diversified array of investments. A third factor is advocacy, not only when the terms of investment are being negotiated, but throughout the fund life. Smaller investors are typically not able to advocate for themselves in the same way that larger ones can, not only with respect to terms, but also negotiating for a seat on the Limited Partner Advisory Committee (LPAC), which is a voice for the investor even after commitments are made. Even if access and sufficient diversification are obtained, these strategies will require a staff member to manage the cashflows involved for the calls and distributions for the underlying investments.

Russell Investments has worked with many large investors that have successfully built their own private capital portfolios, but we have found, for the reasons discussed in this paper, that this is not the preferred route for most smaller organizations. For smaller organizations, we would recommend working with a partner that can provide the following four services.

1. Use existing relationships and investment research and operational due diligence expertise to gain access to top quartile managers.
2. Pool client investments together so that small investors can properly diversify across managers, strategies and vintage year; and help align exposures within the private capital portfolio.
3. Advocate for clients prior to investment, and throughout the fund life, by negotiating terms at the outset and having ongoing conversations with managers and participating in LPACs (when possible) during the fund life to ensure the strategy is being followed.
4. Provide administrative support to manage the cashflows associated with calls and distributions across underlying investments.

By working with a partner, smaller organizations can invest in private capital as if they had the scale, access and internal staff of a larger investor.

Care in implementation efficiency is key to improving the endowment model and helping it remain relevant for all types of investors

Successful implementation of the endowment model, or any investing philosophy, is a combination of ensuring that no return source is overlooked, and that your investment program is efficiently executed and managed. For larger organizations, successful implementation might mean using your scale, access and resources to get strategic advice from a consultant and implement it with your in-house team. For many small and mid-sized endowments, successful implementation might look much different.

If you want to pursue a version of the endowment model but don’t have the resources to successfully harness returns from the illiquidity premia, specialized alpha sources, alternative risk premia and dynamic management, consider working with a partner with the tools, scale, access, team and resources to efficiently implement on your behalf. By harnessing additional return sources, you can increase the likelihood of long-term success. No matter your size or desired investment model, we encourage you to realistically assess your ability to implement the model efficiently, and to identify where the additional resources of a skilled external partner would be beneficial.

[1] It is possible that the risk and return parameters cannot be aligned with a recommended portfolio in the case of committees that have high return targets, but a low tolerance for risk. In these cases, before a portfolio can be designed, there must be education on the impact of different risk levels on the likelihood of meeting long-term goals. Once the committee has determined the preferred trade-off between risk and return, the design process can continue.

For more information

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