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# ENDOWMENTS ENVY

## IMITATION AND INNOVATION IN THE ALTERNATIVES AGE

Envy is a certain outcome of any serious competitive endeavor. As the endowment funds of elite US universities, such as Yale, Harvard and Princeton, continue to post investment returns well ahead of the mainstream, many institutions have tried to emulate their winning strategies by allocating aggressively to alternatives. But will strategies hatched in the past deliver the outperformance that new followers desire? And what other examples should the mainstream follow from the universities' success? SIMON MUMME reports on the innovation, and imitation, that has been spurred by the endowments phenomenon.

Socrates deemed it an “ulcer of the soul”, after Heraclitus, speaking more than a century earlier, said that “our envy always lasts longer than the happiness of those we envy”. Writers and prophets of many nations and creeds, from Shakespeare to Mohammed, warn us of the harm that visits people who are irredeemably jealous of their peers’ success. At its worst, “our envy of others devours us most of all,” wrote the late Alexander Solzhenitsyn.

In the intensely competitive world of institutional investment, envy might not only affect individuals, but also the big licks of capital at stake. The endowment funds of elite US universities - such as Yale, Harvard, Stanford and Princeton - have shot to prominence in the past decade as they pioneered new models of asset allocation that produced stellar returns, effectively scoring a “triple crown” of market-leading returns, committed diversification and ample “sex appeal”, according to Gareth Abley, the head of asset consulting at MLC Implemented Consulting.

Their success is underscored by an emphatic consistency: between 1996 and 2005, more than 5 per cent of US endowments beat the top percentile return for an American corporate pension fund with more than US\$100 million in assets.

This superiority of the leading schools was particularly visible in 2000 and 2001, when the excess returns achieved by endowments of Ivy League universities, along with Duke, MIT, Caltech and Stanford, outperformed those of other schools by up to 10 per cent. In 2000, for instance, the average excess return from endowments reporting at least 10 years of performance data between 1992 and 2005 was roughly 8 per cent, while the elites generated returns north of 26 per cent.

Such achievements have been driven by maverick calls on strategic asset allocation (SAA) that showed a willingness to invest heavily in alternatives and other illiquid assets, combined with the governance to pull it off. For example, at the end of financial 2006, Yale aimed to hold 69 per cent of its portfolio in private equity, hedge funds, and real estate. As the returns rolled in, headlined by Yale’s annual 17.2 per cent return in the decade to 2007, the institutional mainstream, stuck in dotcom wreckage, rightly took notice. ‘Endowments envy’ crept up on US pension funds and played on the minds of investment committee members.

Since then, a surge towards managers and assets carrying the ‘alternative’ tag has reshaped the institutional landscape. As more funds’ asset allocations were reworked in the image of those published by the endowments, the dangers of replication became clear. The alternatives universe does not hold enough opportunities for everyone to shoot the lights out, and not all funds are as well resourced, or have the same tolerance for illiquidity, as the endowments.

Ian Kennedy, director of research at Cambridge Associates, a consultancy to clients including Harvard, Yale, Stanford and the largest American university endowments, says the supply of attractive opportunities in the alternatives universe has not been depleted. “We have seen a marked improvement in the quality of opportunities in the hedge fund world, and the number of quality hedge funds expand,” Kennedy says.

### **Those other secrets of the academy**

“The investment world is different from most other worlds,” writes Kennedy in a 2008 Cambridge Associates publication, *Endowment Management*. “In other professions, doing more of what has worked is usually the route to success...and committee members who cannot grasp this fundamental fact often end up chasing last year’s winners, inflicting considerable damage on the portfolio as a result.”

Since asset allocations must earn approval from fund boards and committees, there is value in looking beyond the first-mover advantages gained by the top endowments in emerging sectors, and instead focusing on their decision-making approaches. After all, their portfolios are produced by combinations of skill and governance. *Secrets (Secrets of the Academy: The Drivers of University Endowment Success; Josh Lerner, Antoinette Schoar and Jialan Wang, MIT Sloan School of Management 2007)*, points out that while volumes have been written on the pricing, risks and returns of various assets, the “organisational economics of investing” are harder to quantify.

The risks taken by endowments involve being early, taking a contrary view, and sometimes being wrong. *Secrets* shows that the overall performance of endowments is counter-cyclical to the mainstream: in the mid-1990s, their excess returns were near 10 per cent; however, during 2000 and 2001, they generated 15 per cent alpha. In taking such risks, they draw on sophisticated advisers and contacts and exploit their high tolerances for illiquidity. When endowments are advised by the likes of Cambridge Associates (which was early in recommending venture capital, leveraged buy-outs, hedge funds, timberland, oil and gas opportunities to clients) and have networks of alumni in the top echelons of the investment world, it is difficult for the mainstream to compete seriously with the universities.

“Partnering with who you invest in and being able to tolerate massive periods of underperformance over a number of years is far more replicable than trying to emulate a strategy that worked 10 years ago.” Obsessing over what worked well yesterday is an all too common mistake, Kennedy of Cambridge Associates says.

“But if you have a strong governance structure, it forces you to seek to understand what is likely to work well tomorrow.”

### **Tomorrow’s strategies**

Effective investing, for endowments and institutions, “is about understanding what you have a competitive advantage in and exploiting that,” Kennedy says. Some endowments

now staff teams searching only for new inefficiencies, similar to the way teams are traditionally assigned to specific asset classes, such as global equities or domestic equities.

“It’s difficult to take a maverick risk if your constituency is relatively uneducated,” Kennedy says. This lack of sophistication takes place in a market where funds compete for members.

Where a super fund has thousands of stakeholders, an endowment has one: its university. Unlike most superannuants, it is an extremely astute constituent with many faces. And while a super fund answers to plenty of members, endowment managers must answer to various academic departments and councils, which can also be frightening. “How would you like it if part of your constituency was the economics department of Harvard?” Kennedy asks.

Super funds must manage liquidity to meet multiple timeframes, while endowments have a timeframe of forever. As a general rule, endowments must pay out their real rates of return to patron institutions to fund research, curriculum development and other activities.

The investment and capital management division of The University of Sydney, which manages an endowment portfolio, aims to distribute 5 per cent of assets, adjusted for inflation, each year.

Endowments seek to provide “inter-generational equity”, in which they spend as much on the current student corpus as the next, Kennedy says. In times of short-term pain, the constituents of endowments are more engaged and understanding, and generally more forgiving, than super fund members.

In searching for attractive alternative assets, both endowments and pension funds encounter limits on the resources available to aggressively scour markets for opportunities. Here, Kennedy says, the challenge is to deploy internal and external resources for the purpose of exploiting strong competencies.

“The key is not to always be looking for niche investments, but to understand what your key competitive advantage is and focus on this far more than what competitors are doing. And if you don’t have the resources in-house to exploit it, you have to reach out,” Kennedy says. “It comes down to aligning good governance with explicit policies aimed at achieving explicit objectives, and the discipline to implement these through asset allocation and resource allocation decisions to exploit your competitive advantage. What’s hard is getting a group of people to implement this in a disciplined way.

Ideally, this culture would be sustainable, too. Writing in *Endowment Management*, Kennedy asserts that “the best governance structure is an empty shell unless populated by knowledgeable people capable of making sound decisions.”

He recommends that at least some investment committee members have professional institutional experience, but not to over-specialise: too many investment professionals with similar backgrounds “may lead to deleterious group-think”.

Representatives of stakeholders in the fund, such as those representing employee members of a super fund or from the university board - should be included.

Specialised investment knowledge should not be considered a qualifier for entry. Also, “neither eminence nor expertise are sufficient to compensate for a failure to participate in meetings”. The best committee members are open-minded, act quickly to fix problems, ask appropriate questions, and are accustomed to making decisions, Kennedy continues. The very worst are overconfident, successful, ‘can-do’ individuals who are impatient with developing a consensus and believe that any lack of knowledge they have should not impede how they manage the fund portfolio.

While staff turnover does not usually carry positive implications, and some endowments have benefited from the decades-long tenures of investment committee members, there are just as many examples of “sclerosis endured by institutions that have failed to inject new blood into their committees,” Kennedy writes.

Tenures should be long enough to ensure consistency and accountability for decisions, but limited to ensure vibrancy. It is important to have the flexibility to renew or extend terms so that the services of excellent committee members are retained. And when it comes to consultants, only those with spine should make the second interview. “Yes-men are useless and poodles come cheaper,” Kennedy says.

Smaller funds that have come late to alternatives can learn much from the successes of the elite endowments and the mixed results from the mainstream’s charge into the sector.

*By: Simon Mumme*

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