

A Question and Answer with Jim Bailey

Co-Founder of Cambridge Associates



James N. Bailey

Jim is a co-founder of Cambridge Associates. In addition to his work at Cambridge Associates, Jim is also co-founder, Treasurer, and Director of The Plymouth Rock Company, Direct Response Corporation, and Homeowner's Direct Corporation, all U.S. personal lines insurance companies. He serves as a director of AIMCO, the largest U.S. multi-family apartment Real Estate Investment Trust, and Getty Images, Inc., the world's leading stock photography company. He is also an overseer of the New England Aquarium.

Jim received his AB *magna cum laude* from Harvard University in 1969, after which he enrolled in the first class of Harvard Business and Harvard Law Schools' joint program. There, in 1973, he received his MBA and JD degrees from Harvard Business School and Harvard Law School, respectively. Jim is a member of the Massachusetts Bar and the American Bar Associations.

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What was the approach to overseeing endowments prior to your original work with Harvard? What opportunities did you see that led to the founding of Cambridge Associates?

When Cambridge Associates was founded in 1973, a major change had just begun occurring in the oversight of endowments. Prior to this time, with a few exceptions, everything was 50 percent U.S. stocks, 50 percent U.S. bonds, mainly with large banks, or large independent investment counsel firms. But, basically, the process of setting investment objectives and asset allocation policies, selecting managers, and measuring and evaluating performance were largely functions that were done externally by the outside investment managers that were hired, as opposed to being done internally or centrally with an advisor, where an investor would look at them independently of the manager. Essentially, it was a single manager or, at most, a couple of managers. It was basically balanced fund management and what today you would characterize as an undiversified portfolio.

Beginning in the 1960s, however, large pension funds had begun to separate the objective setting, the policy setting, and the performance measurement from the managers, doing it more systematically, more comprehensively than in the manager-dominated era. That approach became quite common with large pension funds by the early 1970s. In 1972, I wrote a paper for my Harvard business and law program that looked at the risk-adjusted performance of the pension funds that had adopted the centralized approach versus those that

had kept with the balanced managers approach, and the evidence showed that they had enjoyed superior returns on a risk-adjusted basis than the ones who had used the balanced approach. So pension funds had begun doing something different, but this approach had been, by and large, ignored in the endowment area, with a few notable exceptions.

At the same time, two reports commissioned by the Ford Foundation in the late 1960s, *Managing Endowments* and *The Law and the Lore*, led an effort to shift the law, and the perception of the law, from the historic prudent man approach to what became known as institutional investment management. This led to the drafting of a model Institutional Investment Act, which essentially changed the way that people looked at endowment funds and made total return investing and spending permissible, as opposed to income-only investing. This paved the way for consideration of more risky and diversifying "alternative" investments, which would previously have not been permissible under the prudent man law in place prior to this shift.

Was there a catalyst that gave you the idea and opportunity to start the firm?

In June 1973, Harvard changed Treasurers. George Putnam, the new Treasurer, began considering what Harvard should do to effectively manage the endowment and move it forward. Then, Harvard had a billion-dollar endowment, and it happened to be the peak of the market. While I was in graduate school, I worked on various studies for George and for the Harvard Board of Overseers, and I knew Harvard very well.

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As I sat in my classes at Harvard, I started to realize that everything I was learning at this business school, as far as I could tell, had never been applied to how they ran the financial side of the University. And so Hunter and I got the idea to apply the more modern investment and financial planning techniques to the management of nonprofit endowed institutions. We decided that we should create a company that focused on this, that there was a niche there. And since pension funds had already separated the management from the oversight and started to go in a more diversified direction, we had a model to follow.

Once I graduated, Hunter left his job and we launched the business. We formally launched what became Cambridge Associates in May 1973. Our general strategy was to provide investment and financial planning and consulting services for nonprofit endowed institutions, including collecting information on institutions, asset classes, and managers; offering advice; and providing performance measurement services.

Then, just six weeks after we launched the firm, George hired our firm to undertake a study reviewing the alternative ways that one could manage the endowment for Harvard. It was just blind luck that they happened to be willing to hire us.

What was the focus of the study you conducted for Harvard in those early years?

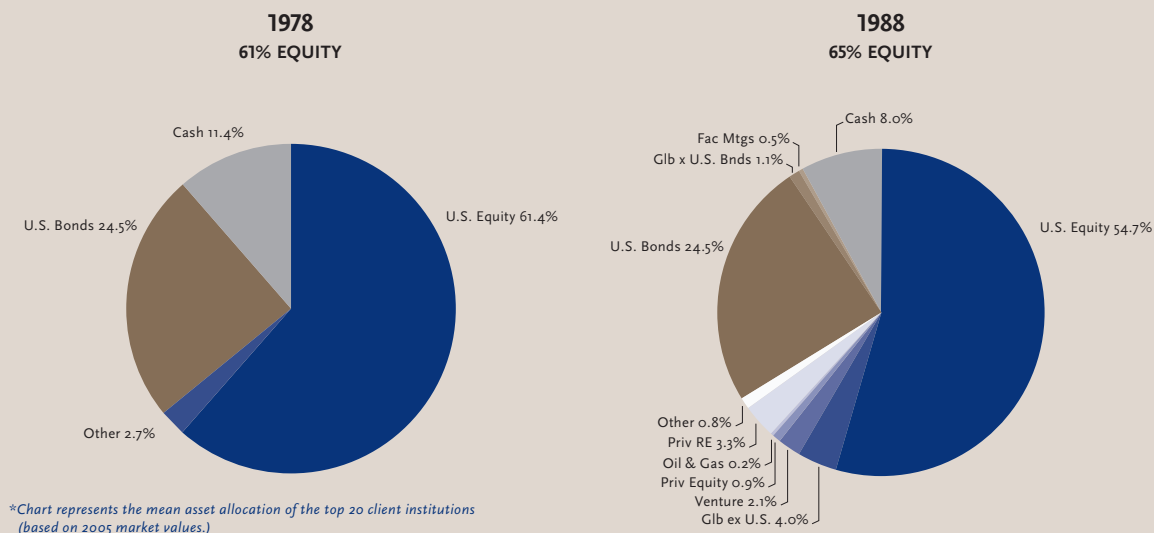
The first leg of the study was to set investment objectives and investment policies for the endowment. And that, in turn, led to the question: What were the alternative approaches? We observed and talked to many of the leading endowments at that time, including Yale, University of Pennsylvania, and the Ford Foundation, to name a few, to see what was working and what was not.

Eventually, we came up with the idea of Harvard establishing a wholly owned nonprofit subsidiary management company, which would be responsible for all of the oversight functions, and also, based on this analysis, would become the predominant investment manager of the fund, using outside managers to supplement that. The general thinking was that the asset allocation and oversight functions would be better informed if you hire people who have been managing assets, that there's a virtue to having the investment management function and the oversight function within the organization. Also for them, given their size, it was cheaper.

Was the work you and Hunter conducted back in the 1970s very different from what the firm does today?

No, not at all. From 1973 through 1977, we did a series of reports on different asset classes and

The Evolution of Asset Allocation Among Large College and University Endowments*



their respective place in the endowment, including venture capital, U.S. real estate, non-U.S. equities and bonds, etc. We analyzed venture capital from both a legal and functional investment approach because it was not clear that it was legal under the prudent man rule. We reviewed the returns and correlations and drew on historical information available at the time. That led to Harvard adopting a 2 percent target allocation to venture by 1975.

We immediately used that data to create a report for our second group of clients, a group of 11 other colleges and universities that joined the firm by 1975¹. That original group, just as we offer today, got consulting advice, ongoing research on asset classes and managers, comparative data, periodic conferences, and performance measurement services among other things.

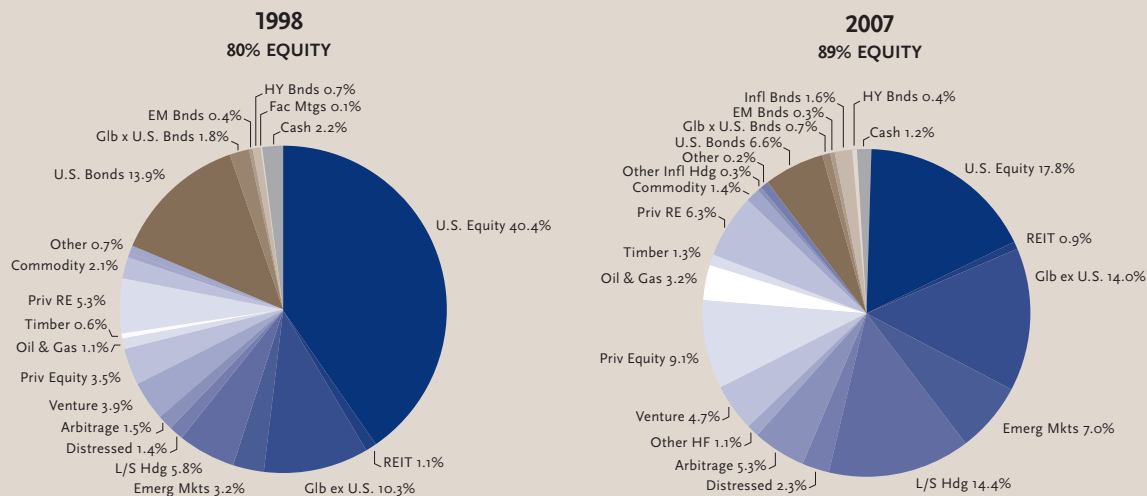
By 1978, we were conducting and writing research on hedge funds and, later, oil & gas, timber, and small-cap equities. In the 1980s, as additional asset classes began to emerge, we separated arbitrage hedge funds from the long/short hedge funds, and wrote research papers on each of them. Then, as we do today, we went through each asset class, looking at its characteristics, its place in the portfolio, the managers that were in the asset class, and our view on its appropriateness in the portfolio.

Did you encounter resistance early on given that the ideas were so radical for the time?

Yes, a bit. It was not particularly easy to get these asset classes adopted in those early days because there was not a lot of historical data that neatly illustrated the correlations, expected returns, and risk levels. In addition, the law was changing, in terms of whether it was permitted. Finally, people were skeptical because there was no precedent or good model for the success of this strategy in the endowment arena. And so, at the time, there were three perceived big risks:

- 1) Legal risk,
- 2) Embarrassment risk (what if this approach “blows up?”), and
- 3) Implementation risk (are there managers that can effectively manage this?).

So, during 1974–75, we went through all of those issues for our clients, publishing white papers. And then, as we do today, we published ongoing updates and tried to make the case for each of these asset classes as being prudent, legal, and effective for the portfolio. We advocated these as something that these institutions *could* do, in terms of finding managers that had skill, and then being something that investors could measure, evaluate, and control. That was the genesis, in my view, of what today is the conventional high equity allocation, high diversification approach.



¹The original 12 clients of CA included Amherst College, California Institute of Technology, Dartmouth College, Harvard College, Johns Hopkins University, Massachusetts Institute of Technology, University of Notre Dame, Princeton University, University of Southern California, Stanford University, Wesleyan University, and Yale University.

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So, the seeds were planted, so to speak, on virtually all major asset classes from the mid-1970s to the early 1980s, and they blossomed during the 1980s. By the time the 1990s arrived, our original clients had mature, diversified programs, which is why it's difficult for institutions to replicate the results of these leading endowments today.

How is the firm different today than it was during those early years?

Well, clearly, our footprint is much broader today. We now have a global presence and specialized research resources segmented by asset class and geographical location. Our ability to intensively oversee and implement complex investment strategies has grown exponentially due to our level of expertise, economies of scale, and global reach.

We've also seen our business branch out to other types of institutional investors such as private clients, pension funds, and more recently, sovereign wealth funds. But, while our firm has grown significantly, our focus has always remained the same—to serve our clients by trying to stay ahead of the best new investment ideas. We truly believe that the services we provide to our clients today are as important as they were for our original client base. There isn't any reason why we cannot continue doing it forever, as long as we stick to that original goal—we must continue to innovate, and must continue to figure out what's going to work best for our clients tomorrow. ■
