



Endowment Investing Revisited

Executive Summary

In November 2009, we published a white paper on the endowment model of investing (*The Yale Endowment Model of Investing is Not Dead*) that argued that the melt down at certain endowments had nothing to do with purported flaws in modern portfolio theory. Now that the financial crisis has receded, we thought it would be instructive to take a fresh look at some of these same endowments to see what lessons they learned and what, if any, changes they made to the constructions of their portfolios.

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With the dust settled and markets on the rebound many people might have expected chastened endowment managers to change their approach to avoid an embarrassing *deja vu*.

Yet despite giant paper losses during the depths of 2009, the aftermath has only served to strengthen the conviction of endowment managers -- and rightly so -- in their beloved endowment model. The one difference is a tweak or two in handling liquidity.

In November 2009, we published a white paper on the endowment model of investing¹ (*The Yale Endowment Model of Investing is Not Dead*) that argued that the melt down at certain endowments had nothing to do with purported flaws in modern portfolio theory. Instead, the breakdown was caused by a failure to model for truly extreme events. Given the enormous obligations of many Ivy League endowments to fund general university operations, their portfolios were positioned on the wrong point of the efficient frontier. In other words, given their current liabilities, they simply invested far *too little* in cash and liquid assets rather than *too much* in alternatives like private equity.

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Table 1: Asset Allocations for Select Endowments

Endowment	Hedge Funds	Domestic Equity	Bonds	Foreign Equity	Private Equity	Real Assets	Cash
Harvard	18%	11%	11%	22%	13%	26%	-3%
Yale	25%	10%	4%	15%	20%	29%	-4%
Avg. Education Endowment	22%	22%	12%	20%	9%	14%	2%

Policy/Target Portfolios

All endowments construct theoretical portfolios allocated among a mix of asset classes designed to return and risk over the long term. Our thesis in the original white paper was that the allocation to cash was too low. Let's take a look at Harvard and Yale, by far the two largest endowments, to see how they have adjusted their respective allocations to cash.

¹ "The term 'endowment model' is often used to describe a theory and practice of investing, first used by major endowments including Harvard, Yale and others starting in the 1990s. The model is characterized by highly-diversified, long-term portfolios that differ from a traditional stock/bond mix in that they include allocations to less-traditional and less-liquid asset categories, such as private equity and real estate as well as absolute return strategies." Harvard Management Company Endowment Report, October 2010.

Harvard Learns Lesson

Harvard appears to have learned a lesson from the financial crisis. Specifically, they have made a major adjustment to the endowment's "policy portfolio" allocation to cash. In 1995, the target for cash was -5%. In 2005, the target was still -5%. In 2010, the policy target swung by 7 percentage points to a new target allocation of 2%.²

Set forth below are a few telling extracts from Harvard's most recent endowment report:

- ∞ "On the topic of limited partnerships, we also intend to continue to reduce uncalled capital commitments to real estate and private equity fund managers. Our uncalled capital commitments at the end of fiscal year 2010, were \$6.6 billion, down from over \$11 billion two years ago."³
- ∞ "We have attended closely over the last two years to *liquidity* [emphasis added], capital commitments and risk management...."⁴
- ∞ "We also need to be mindful that our portfolio, while large, still operates under *liquidity constraints* [emphasis added] and spending demands that are greater than they were 5-10 years ago. The endowment now funds 35% of the total University budget."⁵
- ∞ "Can our strategies and insights be improved? Yes. We learned some specific lessons over the last two years about keeping control of our capital and being prepared for unexpected market conditions."⁶

Yale Changes Course

Similar to Harvard, Yale's endowment funds 38% of the University's operating budget.

In 2005, Yale had an actual 1.9% allocation to cash (compared to Harvard's target allocation of -5% in the same year). By 2009, Yale's actual allocation to cash had flipped to -1.9% (compared to their target of 0.5%). As of the 2010 fiscal year, Yale's target allocation for cash stood at 4%.⁷

Set forth below are some of Yale's comments on liquidity as of June 2009 (the date of the University's most recently published endowment report):

- ∞ "Prudent investors maintain sufficient liquidity to meet the full range of portfolio commitments, which, in the case of an endowment fund, include annual spending distributions and contractual commitments to external money managers."⁸
- ∞ "Even with a zero allocation to cash in the portfolio, investment holdings generate a fair amount of natural liquidity. For instance, bonds pay interest, stocks pay dividends, real

² Ibid.

³ Ibid.

⁴ Ibid.

⁵ Ibid.

⁶ Ibid.

⁷ The 2009 Yale Endowment Report.

⁸ Ibid.

estate produces rents, energy reserves provide returns on capital as well as returns of capital (through depletion), and private equity partnerships distribute proceeds from realizations.”⁹

- ∞ “Liquidity matters, even to portfolios with modest spending requirements and long-term horizons. By putting in place mechanisms to tap a variety of internal and external sources of liquidity, endowment managers provide the means for educational institutions to satisfy the full range of portfolio commitments.”¹⁰

Conclusion

Harvard’s 2010 endowment report asks the question bluntly: “Has the ‘endowment model’ run its course?” Harvard’s response: “Our answer is No. We continue to believe that the creation of a diversified portfolio including significant exposure to a variety of alternative assets has been a major factor in HMC’s [Harvard Management Company] long-term success.”¹¹

We agree wholeheartedly. The only difference now is that both Harvard and Yale have enough cash in their portfolios to fund their considerable and ongoing operating budgets obligations.

About Keating Investments:

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⁹ Ibid.

¹⁰ Ibid.

¹¹ Harvard Endowment Report.