What the Big Names are Doing:

Influences of Endowments & Foundations in the Investment Philosophy

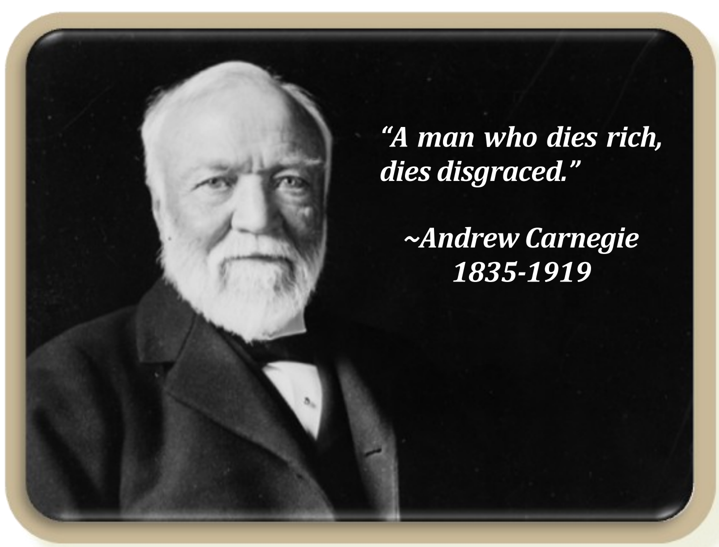
By Kevin Chambers

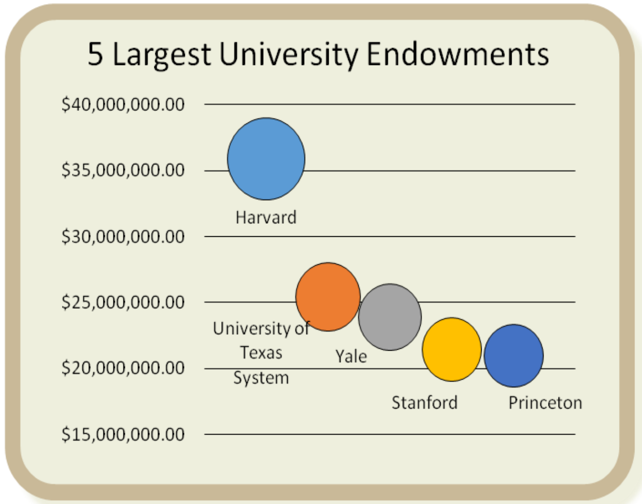
Endowments and foundations are investment funds set up by institutions. Endowments are established by universities, colleges, hospitals, churches, and other non-profit entities. The funds generate income, and the institution takes regular withdrawals to pay for operations, grants, or other purposes. Foundations are slightly different than endowments. They are not usually set up to help with operation expenses of an institution; rather they are used for a charitable cause. Foundations can also be set up as the charitable arm of a for-profit entity. Endowment and foundation funds are established and invested with the understanding that they are to exist in perpetuity.

History of Endowments & Foundations:

In the United States, there is significant money in endowments and foundations. The history of endowments starts even before independence. In 1638, John Harvard left his library collection and half of his estate to the newly formed Harvard College. In 1715, Elihu Yale gave a large gift to the Collegiate School of Connecticut. The college changed their name in his honor in 1718 (Burlingame, 2004). Now Harvard and Yale have the two largest university endowments in the country.

The creation of the foundation culture in the US was highly influenced by Andrew Carnegie. Carnegie, a leader in the US steel industry, was one of the most successful industrialists in the 19th century. He is considered the 2nd richest American of all time with a current equivalent of $310 billion when adjusted for inflation (Warner, 2014). In 1889, Carnegie wrote an article called "The Gospel of Wealth," in which he dictates a responsibility for the new ultra-rich class of Americans to spread their wealth around the country through philanthropy. This was in stark contrast to the European traditions of passing wealth down through your family tree that most Americans were accustomed to understand. Carnegie argued that it is the responsibility for the rich to use their wealth in ways that will best benefit society, not just their heirs (Carnegie, 1889).

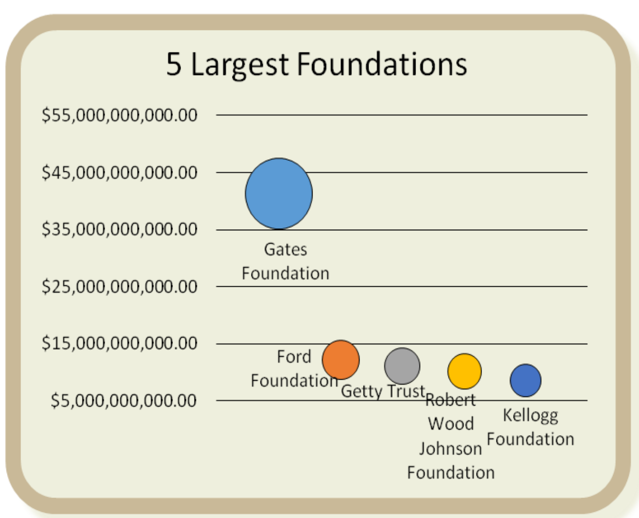




Source: NABUCO

Carnegie endowed many institutions including the Carnegie Libraries, Carnegie Corporation of New York, Carnegie Endowment for International Peace, Carnegie Hero Fund, Carnegie Mellon University, and Carnegie Museums of Pittsburgh. Carnegie's most famous quote is probably "the man who dies rich, dies disgraced." He reportedly gave away almost all his money to various charities. He left his family enough to live comfortably, but not a fortune (Sorvino, 2014). Carnegie ushered in a tradition of institutionalized philanthropy by America's wealthy followed soon by Rockefeller and Ford.

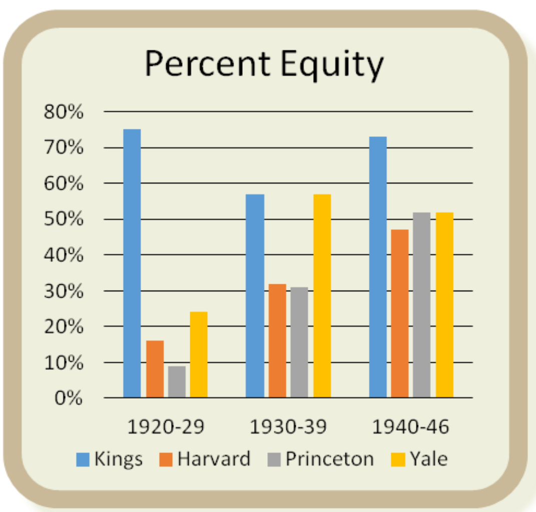
There are over 1.5 million non-profit organizations in the US. The average size of the 100 largest foundations is about $3 billion. All of the 5 largest foundations in the US have over $8 billion. The Bill and Melinda Gates Foundation is the largest in the country with over $41 billion in assets. The largest university endowment is Harvard with $33 billion in assets. Because of the large amounts of money and the market power these large institutions have, they are followed very carefully by investment professionals. Their tactical decisions can affect the thinking of the finance world.



Source: Foundation Center

Shifts in Allocation: Equities

The first major shift in endowment asset allocation was just after WWI. King's College, a constituent of the University of Cambridge in England, had a large endowment given to it upon its founding in 1441 by King Henry VI. For centuries, the bulk of the endowment was held in agricultural lands all over the kingdom. Just after WWI the famous economist, and King's College alum, John Maynard Keynes took over control of the endowment. He immediately moved a substantial portion of the discretionary portfolio (about 75%) into equities, a radical change away from the norm of the times. None of the other major endowments in the UK shifted to equities until after WWII. Even the leading US endowments, Harvard, Yale, and Princeton, had significantly lower equity allocations (Chambers, Dimson, & Foo, 2014).



Source: NABUCO

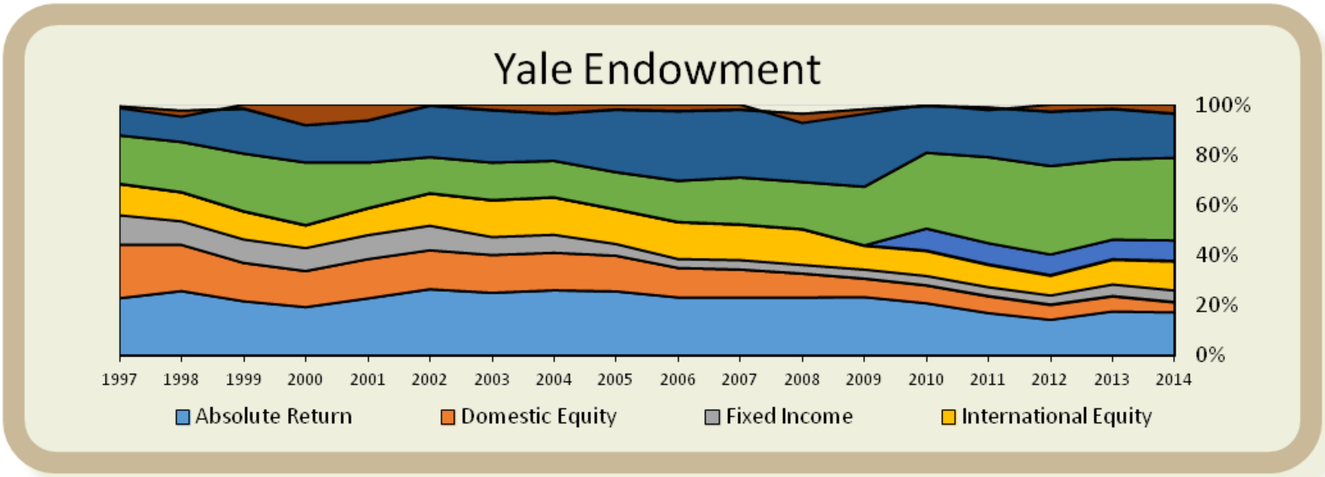
The move Keynes made to equities could have backfired tremendously. He ran the endowment through some very significant economic turbidity. Keynes learned through the financial crisis of 1929 and 1937 that a long term approach and commitment to asset allocation can allow endowments to weather substantial stock market crashes. He constructed an internationally and market capital diverse portfolio, and tried his best to limit costs. Keynes understood the value in having liquid assets and warned about over allocating to illiquid assets, such as real estate. Eventually, most endowments in England and US followed Keynes' innovations and implemented significant allocations to equity. Even today, endowment and foundation asset allocation theory draws on the experiences of Keynes and the King's College Endowment (Chambers, Dimson, & Foo, 2014).

Shifts in Allocation: Alternative Investments

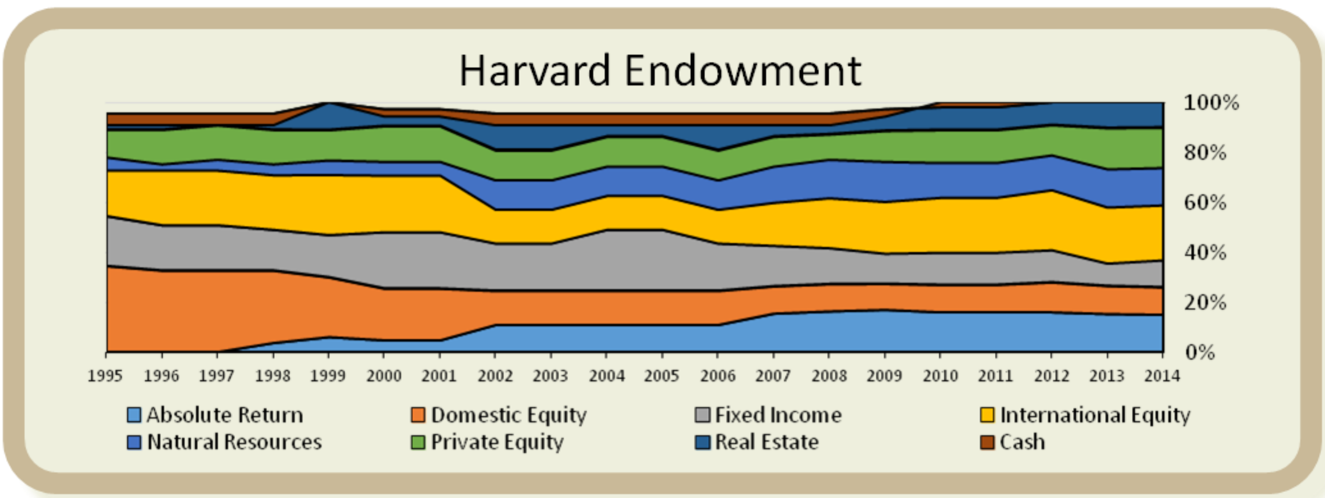
The other major shift in endowment investing was the implementation of what many people call the "Yale Model" of endowment investing. The Yale Model was developed and popularized by David Swensen, the Chief Investment Officer at Yale University since 1985. He is responsible for management decisions concerning the Yale endowment.

Swensen developed the Yale model with Dean Takahashi in the mid-1980s. Following the implementation of this new model, other endowments and institutional investors emulated the strategy. His 2000 book Pioneering Portfolio Management described his theories for endowment investing. Swensen argued for lowering allocations to traditional stocks and bonds and increasing allocations to alternative investments such as hedge funds, private equity, and exotic real assets such as mining, oil fields, and forestry.

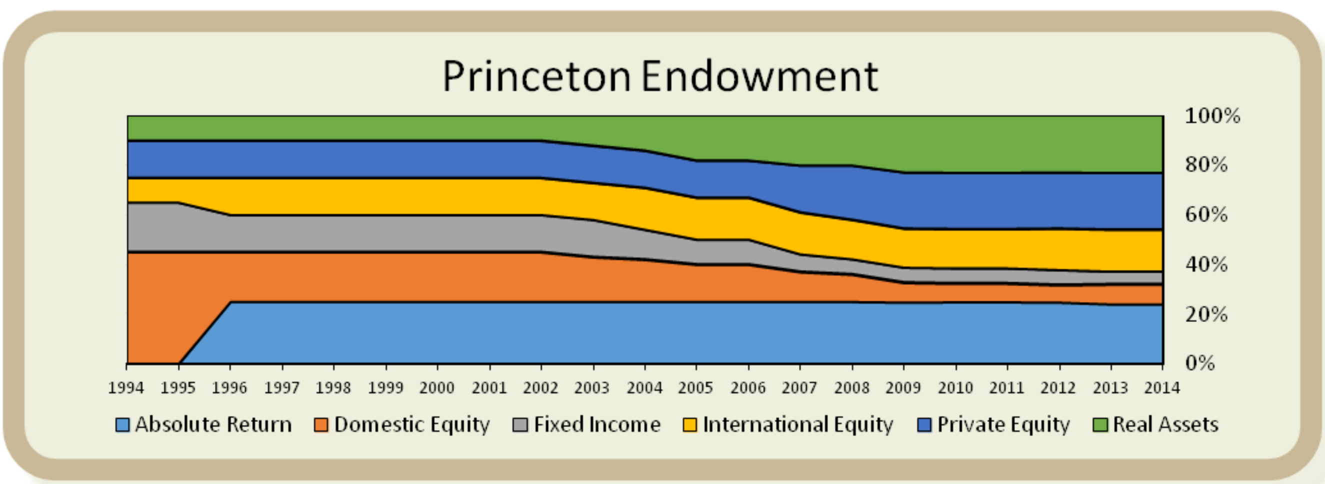
One of the reasons the Yale Model became so popular is that they posted very good returns. In the decade ending in 2008, the Yale Endowment earned an annualized 16.3% return, net of fees. The largest endowments now average more than 60% in hedge funds, private equity, and real assets. In 2009, after a strong decade, the endowment lost -24.6% (fiscal year ending June 30th). However, the ten-year return ending June, 30th 2014, was still 11% annually. The Yale Model has been implemented and imitated by other university endowments, pension funds, and foundations, with varying success. After the 2008 crisis, the Yale model was questioned by many in the investment profession.



Source: Yale Endowment

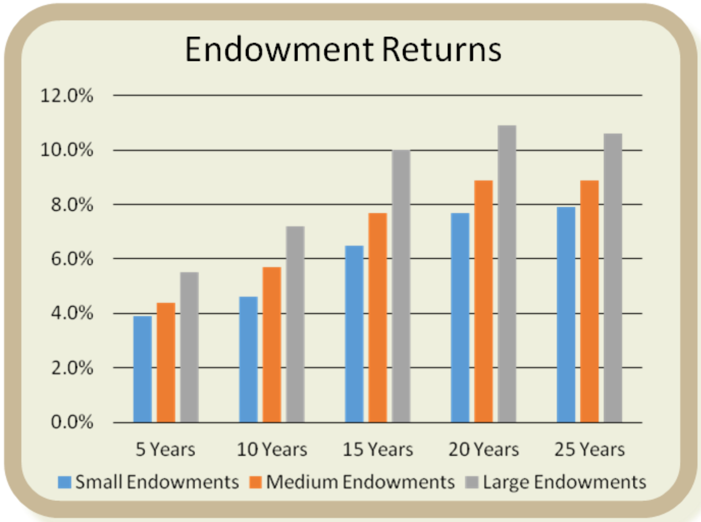


Source: Harvard Endowment



Source: Princeton Endowment

After 2008, a report commissioned by Harvard, whose endowment lost 27% in the year leading up to June, 2009, decided that the Harvard Endowment was holding too much risk prior to the crisis and was going to reevaluate the use of alternatives in their portfolio (Bloomberg, 2010). Vanguard did an in-house analysis of endowment performance over the last 25 years ending in 2012. They found that the top 9% of endowments (73 endowments with over $1 billion) have performed very well, even when including the 2008 crisis (Wallick, Wimmer, & Schlanger, 2012).



Source: Freddie Mac

Ford Foundation

The Ford Foundation was established in 1936 with a gift from Edsel Ford, son of Henry Ford. Since then, the foundation has awarded more than $16 billion in grants. The foundation focuses on strengthening democratic values, reducing poverty and injustice, and advancing human knowledge, creativity, and achievement. Headquartered in New York City and with ten regional offices around the world, the Ford Foundation makes grants in all 50 states and support programs in more than 50 countries.

Getty Foundation

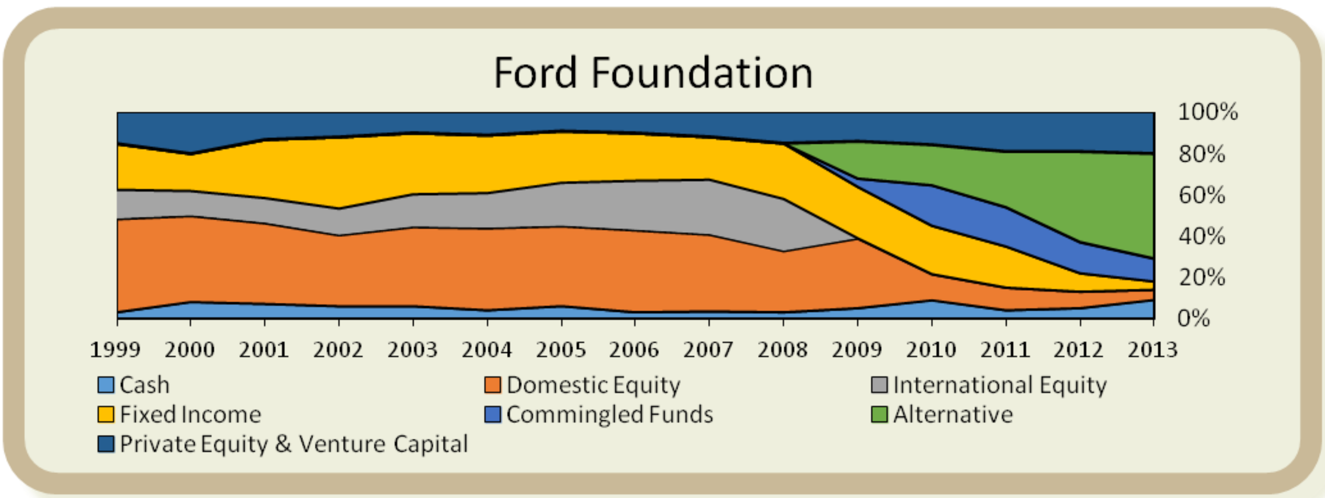
J. Paul Getty, founder of the Getty Oil Company, started the Getty Foundation in 1954 to support the museum of his personal art collection. Upon his death, it became the largest museum endowment in the world. The mission of the Getty Foundation is to strengthen art history as a global discipline, promote the interdisciplinary practice of conservation, increase access to museum and archival collections, and develops current and future leaders in the visual arts. Since 1984, the Getty Foundation has awarded over 7,000 grants benefiting over 180 countries on all seven continents.

Bill & Melinda Gates Foundation

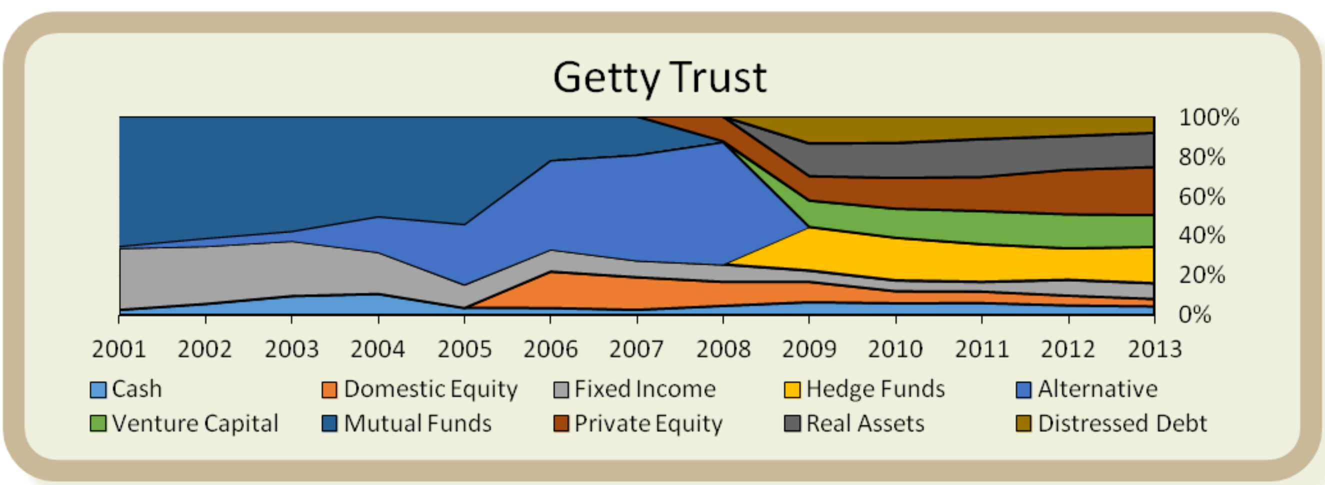
Founded in 2000 from the merging of the William H. Gates Foundation and the Gates Learning Foundation, the Bill & Melinda Gates Foundation is currently the largest foundation in the US. The three priorities of the foundation are global health, global development, and work in the US. Some major projects have included connecting libraries in the US and around the world to the internet, anti-malaria and -polio work, agricultural research and re-vitalization globally, and childhood immunizations. The foundation has six locations worldwide and over 1,200 employees. Grants in 2014 totaled $3.9 billion, supporting projects in all 50 states, the District of Columbia, and more than 100 countries.

However, Vanguard found that the majority of endowments, the small and medium endowments, lag in performance significantly when compared to the performance of billion dollar endowments. They argued that larger endowments have more investment expertise, pricing power, and higher levels of direct investment allowing them to outperform the smaller endowments. They show that a portfolio with a basic 60%-40% stock and bond split with low cost mutual funds outperform the average small and medium endowment (Wallick, Wimmer, & Schlanger, 2012).

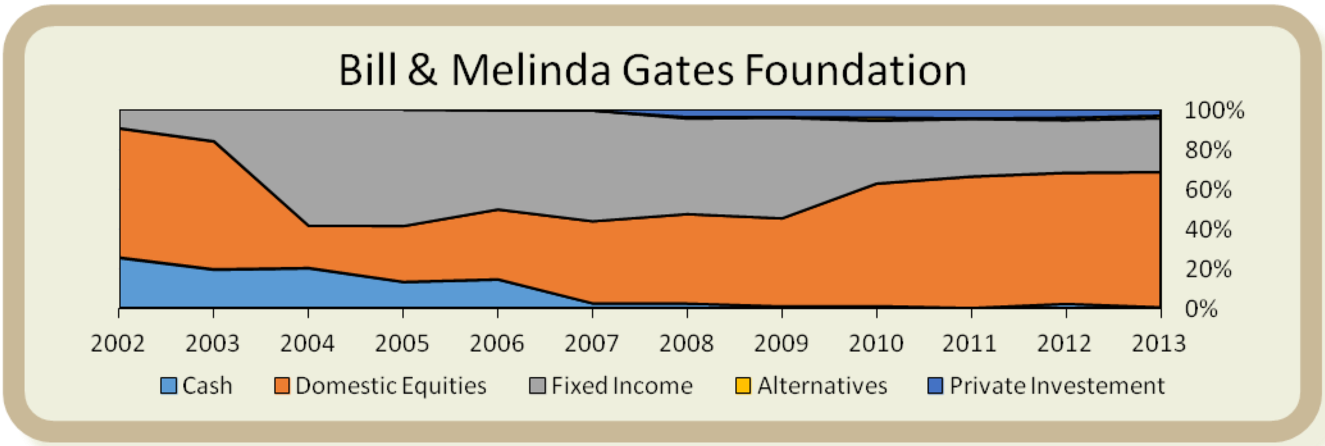
The alternative movement is evident in the largest foundations as well. As examples of some of the largest foundations, we looked at the Ford Foundation and the Getty Foundation . The Ford Foundation increased their allocation to alternative investments after 2008. As of 2013, over 50% of the Ford Foundation assets are in alternatives. Similarly, the Getty Foundation has increased their allocations to alternatives throughout the 2000s. As of 2013, the Getty had almost 75% of their asset spread between hedge funds, private equity, venture capital, and real assets.



Source: Ford Foundation



Source: Getty Trust



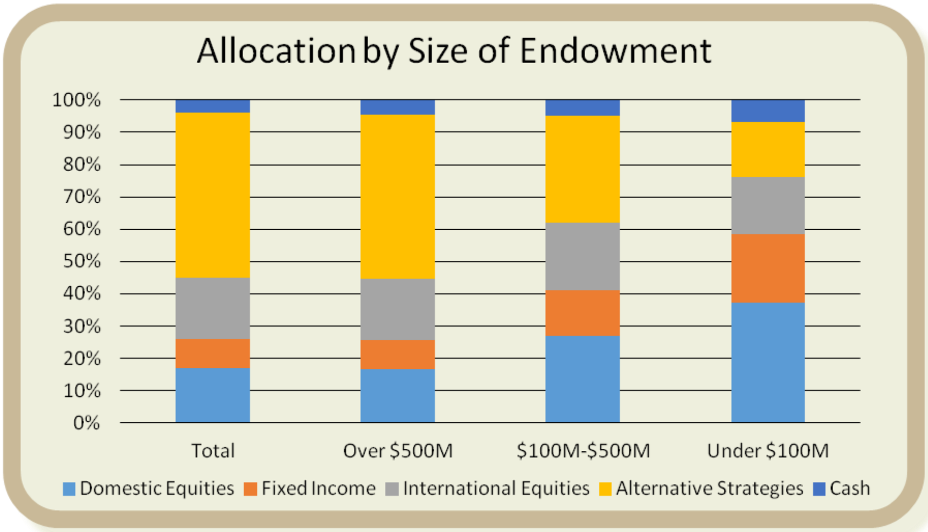
Source: Bill & Melinda Gates Foundation

The Bill and Melinda Gates Foundation asset allocation is different than the majority of other foundations. Their assets are mainly donated investments from Bill and Melinda Gates and Warren Buffet. Over $9 billion of the funds in the foundation are donated Berkshire Hathaway shares. Their portfolio is diversified across lots of different stocks and bonds, at about a 70%-30% split between equities and fixed income. The Gates Trust is managed by a team of outside managers and it holds almost no alternative investments.

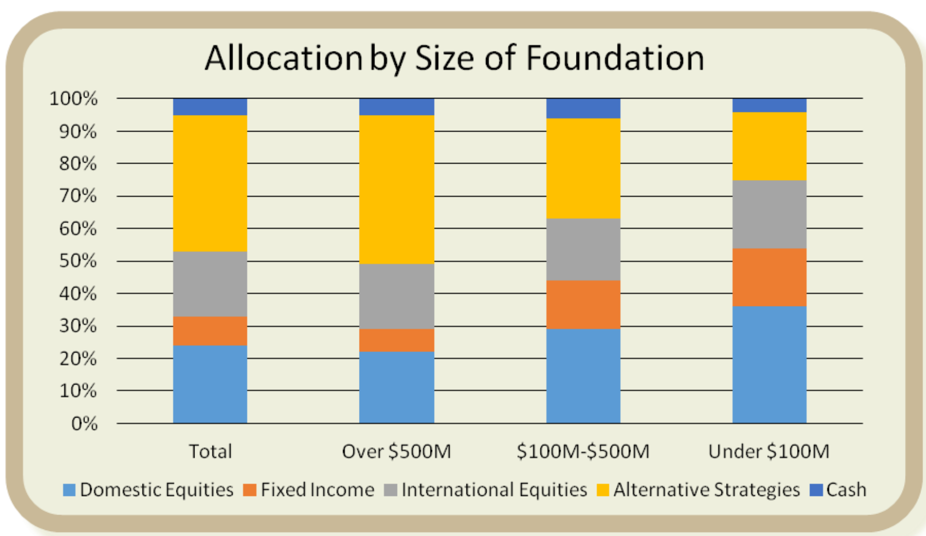
Current State of Foundations and Endowments:

There is about $450 billion in university endowments in the US and about $660 billion in foundations. Endowments average more money per institution, but overall foundations have more money. Allocations are fairly similar for endowments and foundations of similar size. Smaller endowments and foundations (under $100 million) both have about 55% allocations to equity, 20% allocations to fixed income, 20% allocation to alternatives, and 5% to cash. As the asset base grows, institutions typically increases allocations to alternatives and decrease allocations to domestic equity and fixed income. International equity and cash allocations are similar across all institutional asset sizes.

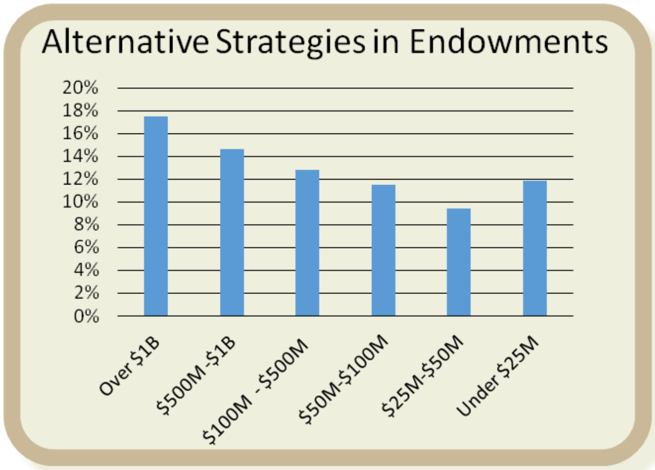
How have these asset allocations faired in the last 10 years? The most up-to-date data is for the 2014 fiscal year ending June 30, 2014. The larger foundations and endowments outperformed by a little over one percentage point better than the smaller counterparts: large endowments and foundations returned 16.5% vs. 15.2% for the smaller.



One contributing factor for the difference is the effectiveness of alternative portfolios in the larger institutions. Confirming Vanguard's assessment, the alternative portions in larger endowments and foundations returned almost 18% versus 12% for the smaller institutions. The returns for the other asset classes are essentially equal across all asset base sizes.



Source: Council on Foundations - Commonfund Study of Investments in Private Foundations 2013



Source: NABUCO

Aggregated performance shows that endowments and foundations performed well in 2014, but did not succeed in beating the stock market over the same period. Their returns are comparable to the returns of a 60% stock and 40% bond portfolio, but slightly under in the 1-, 3-, and 5-year returns and beating it slightly in the 10-year returns.

	1-Year	3-Year	5-Year	10-Year
Total Foundations	15.6%	8.7%	12.0%	6.9%
Total Endowments	15.7%	9.0%	11.6%	7.0%
S&P 500	24.6%	16.6%	18.8%	7.8%
BC Agg	4.4%	3.7%	4.9%	4.9%
60/40 Portfolio	16.0%	9.2%	12.3%	6.6%

Returns ending 6/30/14

Endowments and foundations are an important sector of the financial industry. There are billions of dollars that are at the disposal of the managers of these funds. The allocations and performance of these funds make headline news. However, through an analysis of their performance over the last few years, their performance is not spectacular. The large endowments and foundations that spend money to hire some of the brightest financial minds to run their portfolios barely out perform a 60/40 portfolio. Alternative investments for the largest endowments end up paying off and giving them a small competitive advantage, but the alternative portions of the portfolios of the smaller institutions seem to be less effective.

Some of this performance is hard to judge. In the last 5 years, the stock market has experienced incredible growth. The US stock market has beaten almost every portfolio out there, even the alternative portions of the largest foundations and endowments. The largest foundation in the US, the Gates Foundation, doesn't use any alternative investments, yet the foundation remains competitive and continues to grow their asset base. Many of the larger institutions have started to move away from some alternative investments. Harvard and Yale both announced they would start to pare back their alternative allocations starting this year. A globally diversified, low cost portfolio can work for all sized foundations and endowments.

Applying Lessons Learned:

The genesis of Headwater Investment Consulting was based on experience of our principal, Dr. Scott Chambers, managing and operating endowment funds during his time as Linfield College's Vice President for Finance and Administration. He has done extensive academic research on the investment philosophies behind the largest endowments and foundations. Dr. Chambers has managed, consulted, or otherwise worked with several large endowments other than Linfield's endowment, including W. F. Albright Institute of Archeological Research, Ford Family Foundation, and University of Colorado Foundation. The endowment and foundation sector is still an important part of how we shape our investment philosophy for all of our clients.

Headwater Investments doesn't invest in any alternative asset classes, such as hedge funds or venture capital. Applying the lessons learned by our research of endowments and foundations, our philosophy focuses on creating globally diversified, low-cost portfolios. As a result of these priorities, we favor index mutual funds because they are a low-cost vehicle that provides greater diversification while having generally lower turnover and more consistent performance than most actively managed funds. Headwater Investments does recommend multiple low-cost, diversified, and well-run actively managed funds in specific asset classes or regions. Our firm looks for portfolios that are diversified across hundreds, if not thousands, of securities; manager tenure and reputation also play an important role in our decision-making process.

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