Don't Give Up the Ship: The Future of the Endowment Model

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Endowment funds have long been thought to be the best-managed asset pools in the institutional investment world, employing the most capable people and allocating assets to managers, conventional and alternative, who can and do truly focus on the long run? But, after a decade of subpar performance, documented by Richard Ennis in this issue of the JOURNAL OF PORTFOLIO MANAGEMENT, is this perception still valid? What inherent advantages do endowment funds have, and what special challenges do they face? What are the prospects for the endowment model of investing in the future?

This brief essay tries to answer these questions in the light of capital market theory and realities. But, first, what do we mean by the endowment model? It involves:

- Defining the investment opportunity set to include every asset class in the world, as well as potential profit-generating situations that do not clearly belong to any established asset class
- Treating the investment time horizon as very long or even perpetual, with attention paid to intergenerational equity while retaining the capacity to generate cash as needed by the endowed institution
- Relaxing conventional institutional constraints on leverage, short selling, capital calls, and the ability to sell quickly or even mark to market
- Being mindful of capacity limitations, transaction costs, and liquidity requirements -- the "financial frictions" that do not occupy pride of place in the business-school version of investing but that are vitally important when one goes to implement the theories one has learned.

With all those advantages over other kinds of asset pools, endowments surely ought to be able to deliver superior returns! We'll get to that shortly. But first, a look at the downside of such a structure.

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What's wrong with this picture?

Critics of the endowment model, on the other hand, chuckle at the parody version of the model: "Anything worth doing is worth overdoing." The enthusiasm of some universities and foundations for alternative investments caused them deep pain in the prolonged market downdraft of 2007-2009, and could do so again in an extended bear market. The reason is that liquid investments are, definitionally, the only ones that can be sold to meet the institution's cash needs. If, due to market declines, liquid assets become a small enough share of total assets, the illiquid ones become most or all of the portfolio. The fund may thus become insolvent, unable to delivering the cash that the institution relies on to operate. If the fund is also indebted or contains implied debt because of contractual capital calls (funds promised to managers but not yet delivered), the institution's survival can be threatened (Siegel 2008).

The Two Conditions for selecting active managers

Assuming that all those downsides can be dealt with through sensible risk management and liquidity management -- which may be a bit of a heroic assumption for institutions composed of human beings -- let's explore the possibility of generating superior performance through the endowment model. Early in this century, Barton Waring and I (Waring and Siegel 2003) asserted that, in order to make the decision to manage assets actively rather than just indexing, an asset owner (such as an endowment) had to meet two conditions:

1. One must believe that superior managers exist - that is, that some managers have an expected alpha, after fees and other costs, that is positive not just due to luck or random fluctuation but because they have superior skill, in an environment where all their competitors are also well-informed, intelligent, and hardworking; and

2. One must believe that we, the asset owner or sponsor, have the ability to discern which managers those are.

Note that condition (2) means picking winning managers from a population that must, mathematically, average to the market's or benchmark's performance before costs, and even less than that after costs.

Structural advantages of the endowment model

Endowments seem particularly well suited to meeting the second condition. They pay well, attracting talented and stable staffs. They exist in close proximity to business schools and economics departments, many with Nobel Prize-winning faculty. Managers from all over the world call on them, regarding them as supremely desirable clients.

Endowments have even more advantages over other investors. Unlike mutual funds, they do not have cranky shareholders who invest or liquidate at exactly the wrong time. As a result, they do not usually have to handle awkwardly large cash flows in and out of the fund, or hold "dead weight" positions to satisfy clients' desire for risk control relative to a benchmark. They can invest for the long run, ignoring short-term underperformance in pursuit of a longer-term goal. They do not have to follow pension fund or retirement savings plan regulations. And there is the litany of relaxed constraints I listed earlier.

What more could you possibly want?

Well, one thing would be the freedom to stray outside the conventional asset classes (private equity, hedge funds, real estate, commodities, and so forth), or between them (securities that are not clearly either equity or debt). Endowments have that freedom too. They really do seem ideally positioned to earn excellent returns.

Recent performance: Not so good

However, they only did so, according to Ennis (2021), in one golden decade, roughly 1995-2005. This was the period in which alternative investments, broadly construed, burst onto the institutional investment scene in a serious way and grew from a tiny to a very large proportion of endowment assets. You can only do this once, or once in an investment officer's professional lifetime.

It is, then, no wonder that alternatives struggled once they became big, what is known in the profession as a "crowded trade." (For a non-asset-class, also known as "all other," to become a crowded trade is a neat trick, possible only when trillions flow into it -- but that's exactly what happened.)

Racing against Secretariat

But something else happened in the markets that made the endowment model almost constitutionally incapable of delivering superior returns over the last decade or so. After the market bottom of March 2009, the stock and bond markets *went straight up for 12 years*! Never mind the mini-crashes of 2011, 2015, and 2018, and the much more serious setback of early 2020 -- the compound annual return of the S&P 500 from March 2009 to January 2021 (the most recent month-end at the time of this writing) was 14.52%, as good as any long bull market of the past. Moreover, the bond market did better than expected too. The Barclays Aggregate dollar-based bond index returned 4.25% compounded annually over that period, and long bonds did much better than that. So the surprise component of a conventional equity/ bond benchmark in the "dross decade" for alternatives overwhelmed the expected or normal part of the return.

You can't compete with that using a low-beta strategy, which is what broadly diversified endowment funds usually pursue.

Moreover, a benchmark consisting of 60% in the S&P 500 and 40% in bonds isn't really appropriate for an endowment. The benchmark should be global, and international equities seriously underperformed U.S. stocks during the post-2009 period. Comparing endowment performance to 60% in the MSCI All-Country World Index and 40% in some sort of bond index, endowments almost certainly look better than when compared to the U.S.-only benchmark, although I don't know if they actually beat it. (Beta-adjusting the performance of both the endowment funds and the benchmark, to calculate the true alpha, would also be revealing.)

Looking forward

Traditional asset classes

The huge move to indexing of traditional asset classes, equities and bonds, has caused those markets to become more efficient because of very large number of free riders on each piece of information that active managers gather. This leaves pretty slim pickings for traditional long-only active managers, as can be seen by their miserable performance in the last decade. Active managers do cluster around the value factor, so if there is a long period of outperformance by value in the future, these managers will do better, but … we're waiting, waiting. One could avoid the value tilt by building a portfolio out of style-diversified long-only active managers, but it's likely you'll wind up with a very expensive closet index fund. Usually, it's better just to index.

So the best prospective returns at this time in history (although not always) are, as noted earlier and as Peter Bernstein said long ago,[2] *between* the asset classes or *outside* them.

Between the asset classes

What investment opportunities are located between the asset classes? An example is revenue royalties, a financing method pioneered by Arthur Lipper (Lipper 2019) and also pursued by American Express. A company sells off a portion of its total revenue - like a sales tax - to a manager in exchange for cash. The cash flow stream from the manager's investment isn't equity, it isn't debt -- it's both. It sounds a little like a convertible bond or a junk bond, but it isn't one of those either. It's just an alternative investment. You can't make an index fund out of revenue royalties (maybe someday you will be able to). This is just one special case of investing between the asset classes that I happen to be familiar with - there are many others.

Outside the asset classes

Outside the traditional asset classes lie all the alternative investments that we've become familiar with in the last quarter-century: private equity, hedge funds (a special case that I will cover shortly), real estate, farm and timber land, commodities, infrastructure, intellectual property, environmental assets and liabilities[3] -- anything that is not in the public markets and that is therefore not priced by a community of active managers doing comparative valuation and trying to beat a benchmark.

The pricing of such assets is likely to be very inefficient, enabling investors to make large profits -- and large losses. The big risk in these markets is the inability to distinguish good from bad deals way in advance of any cash flows, with limited ability to gauge one's progress. There is also a principal-agent risk caused by the person making the decision being unlikely to still be in the same job when the investment pays off, or doesn't -- this "time risk" increases the incentive to make investments that look good on paper, with losses, if there are any, to be realized on someone else's watch.

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[2] Personal communication (Ford Foundation staff meeting), early 2000s

[3] See Sandor *et al.* (2014).

Hedge funds: Both inside and outside the traditional universe

Hedge funds are a special case in that they're (mostly) built out of traditional assets -- stocks, bonds, cash, perhaps some commodities or currencies -- but provide anything but traditional return patterns. They are typically long-short, leveraged, and flexible as to what the underlying holdings might be at any given time. It would be fatuous to classify them as anything but alternative, in the sense of producing a return stream that is unrelated, or only weakly related, to the main benchmark assets.

Traditional asset managers become more hedge fund-like

Yet many traditional asset managers are moving toward a more hedge fund-like structure, with long-short products shunting aside traditional long-only active management for reasons in Grinold and Kahn (2000). Their article, originally titled "The Surprisingly Large Impact of the Long-Only Constraint," shows that the relaxation of that constraint produces higher alphas, conditional on the manager having valuable skill, where the increase in alpha is proportionate to the amount of active risk taken.[4] Thus, tightly risk-controlled long-only active still has a place, because you can "short" a lot of stocks relative to the benchmark while still having long positions in the stock in an absolute sense. However, as you move out on the active-risk curve, a long-only strategy hits the no-shorting constraint hard, and alpha is sacrificed. That is the reason for the move from long-only to long-short in the traditional active equity (and bond) world -- stimulated by early adoption on the part of endowment funds.

Conclusion: Alternatives look much better now than they did in 2009

I don't expect much out of stocks and bonds in the next decade. Current equity pricing is just too stretched, unless a near-miracle happens and we get superior earnings growth in the face of huge government budget deficits and record-high corporate profits as a share of the overall economy (a number that tends to mean-revert)…

…but not as stretched as bond pricing. Negative interest rates in many countries, and effectively zero rates in the United States, have never before been seen in the five thousand (!) years of interest rate history documented in Homer and Sylla (2005). Don't get used to it. While bond yields could decline further, it's not the way to bet in the face of mounting debt-to-GDP ratios. There is much more downside risk than upside in the bond market.[5]

In the truly long run I'm never bearish. Liberal capitalism has produced a betterment of human life over the last 200 or 250 years that is reflected in equity returns (and to some extent in bond returns), and we can expect that to continue -- especially in emerging and frontier economies.[6] But in the shorter term you have to invest in *something*, and while you can protect capital by holding cash or laddered TIPS, nobody is going to be satisfied with those returns so you have to

[4] The earlier and more revealingly titled version to which I refer, "The Surprisingly Large Impact of the Long-Only Constraint," was published by Barclays Global Investors (San Francisco) in its in-house journal, *Investment Insights*, volume 3, number 2 (May 2000).

[5] For supporting evidence, focusing on a demography-driven labor shortage that implies higher inflation and interest rates, see Goodhart and Pradhan (2020).

[6] Please see my book (Siegel 2019) on economic history and the future of human betterment.

consider assets that do not have low short-term returns baked into the price. International equities have possibilities, but the alternative assets that make up a large share of the endowment opportunity set offer wider choice and, presumably, better returns for astute selectors of investments.

To conclude, one decade's bad performance for the alternative-asset components of the endowment model doesn't mean anything, especially when the competing assets are two markets that went straight up. You wouldn't boycott stocks after the 1930s or 2000s, or bonds after the 1970s, because they had bad decades.

As naval commander Oliver Hazard Perry said in the long-ago Battle of Lake Erie (which is, today, a peaceful spot for fishermen), Don't Give Up the Ship![7] Nothing is guaranteed, but you just might win. The logical arguments and institutional peculiarities are in your favor.

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[7] While almost universally credited to Perry, he said that the motto consisted of the dying words of a fellow naval commander, Captain James Lawrence.