

Overview of Endowment Asset Allocation

Our discussion assumes that a fund is a perpetual store of value that should deliver an optimal level of funds for current institutional needs as well as future needs and should maintain its inflation-adjusted value after distributions. There are three primary decisions that governing boards make regarding their investment programs. The first is determining the sustainable annual distribution or payout rate that the endowment can deliver while, at a minimum, maintaining the inflation-adjusted value of the principal. This decision requires determination of the investment time horizon and the asset categories and proportions needed to produce an investment return necessary to satisfy the payout rate and preserve the inflation-adjusted value, which is iterative.¹ The second primary decision is exactly how the asset allocation structure will be implemented. Asset allocation and implementation are approximately equal in importance, notwithstanding the conventional view that asset allocation determines over 90% of the return differential among various investment programs. Owning an asset class known as marketable domestic equities, for example, could be interpreted quite differently. One could own only very large capitalized equities, very small capitalized equities, value or growth oriented stocks, certain economic sectors, some combination of the various sub-categories, or the entire market on a capitalization weighted, on an equal weighted or some other basis. The results for a multi-year interval from these various combinations of just domestic equities, although nominally one asset class, could be very different. Therefore, one must also be cognizant of the implementation bias that is expressed for a given asset allocation policy. In brief, manager (portfolio) selection is a critical element of any investment program and asset class or category allocation by itself is insufficient to answer the question of how funds should be invested. The third primary decision is how the governing board will monitor and adjust implementation based upon changing opportunities and risks. Typically this requires quarterly meetings and the willingness to re-balance investment allocations based upon their relative performance, although may require consideration of especially attractive allocations due to changing economic and financial circumstances. An important example of this is the use of commodities in the past two years.

Asset allocation has required the acceptance of what may be non-intuitive factors relating to the important principle of diversification as well as the risks of timing entry to and exit from equity markets. We examine these factors and illustrate their importance to our clients so that they can avoid classic mistakes that have plagued investors.

Our asset allocation studies are intended to serve as discussion frameworks, not precise views of the future, as it is obvious that nobody can predict mean rates of returns accurately. We can use history as a guide, especially with regard to the volatility of asset classes and sub-categories, such as emerging market equities. Standard deviation of return tends to be a reliable value. We developed our key assumptions of mean real rates of return, standard deviation and correlation coefficients based on observation of the longest data series available for each category, tempered by our subjective, generally conservative projections. We have generally lowered return assumptions from historical levels and increased correlations among the various categories to present a more conservative projection. An exception to this is our assumption of hedge fund return and standard deviation, which we prefer to call "less correlated," and is for a higher return than that projected by some who characterize the category as "absolute return."² That is because we have assumed that such investments will consist primarily of long-biased equity funds operating in less efficiently priced sectors of the equity markets, whereas many institutional investors seek essentially zero correlation to the equity market with their hedge fund investments. Enclosed is our recent commentary on hedge funds that provides perspective on our position and that is integral to our asset allocation approach.

¹ It is important to consider how governing boards view their charter. If they believe that they are stewards of the endowment, their investment structure and objective will be to preserve purchasing power after annual distributions. They may, however, assume a more aggressive approach and structure an investment program that seeks to generate a real rate of return in excess of that required to satisfy annual distributions and the inflation-adjusted value of the endowment after such distributions. Such an approach implies greater risk.

² The institutional investment industry has developed its own terms, some of which are more specific and descriptive than others. We find the term "absolute return," which refers to those strategies that are expected to have positive returns in any 12 month (or sometimes less) interval and are also derived from sources that do not depend upon the direction of the marketable equity or debt markets, to be especially specious. Institutional investors use the term in contrast to those who want to earn "relative returns." For starters, we have never encountered an investor who did not want to earn an absolute return. Some investors want such returns in short intervals and are unwilling to accept risk that they will not succeed, while others understand that if they assume more risk, including that of loss of capital, they may earn larger returns. The latter type of investor usually adopts a longer investment horizon over which they expect to earn a given return. To suggest that there are bulletproof strategies that are generally referred to as "absolute return" is, to our way of thinking, misleading. There may be significant risks associated with the non-directional, uncorrelated absolute return strategies. This footnote is already too long so we welcome any questions about our view.

It is worth noting that we have not developed strategic assumptions about real return from commodities, based upon either spot or futures prices, as there is no structural real return that we can identify. The reason for this is that as prices of a physical commodity rise investment in additional production is made or substitutions are developed and eventually prices fall. Of course there are temporary intervals during which physical commodities can increase considerably when there is an imbalance between supply and demand. In recognition of the cyclical nature of commodities, we advised our clients in 2003 to add 5% allocations to the PIMCO Commodity Real Return Fund. Not only has this fund appreciated, but its diversification characteristics are quite dramatic, as it has had an inverse correlation to equities in several quarters. We have advocated allocations to energy long/short hedge funds to our consulting clients since our inception and have maintained such allocations in our discretionary accounts since we began that service in 1998.

While mean returns cannot be known, much less their pattern, standard deviations for the asset categories and subcategories have been somewhat more reliable as a guide. Compounding the difficulty of projections is the tendency for correlations among asset types to converge during periods of market distress, thus reducing the intended diversification when it is needed most. Our asset allocation studies are based on mean variance optimization that has very clear limitations, especially when constrained by practical limits, as return distribution assumptions are unlikely to replicate historical averages.³ However, it does provide a means of testing various assumptions systematically, if not with the degree of confidence that we all may prefer. The asset allocation process includes Monte Carlo simulations that project the endowment value after withdrawals for various time horizons, combinations of market scenarios and allocation structures. Such simulations are an improvement over purely mean variance optimization, but still fall short of delivering the confidence that we would like. We do not attach precision to such projections, but believe that the asset allocation study offers the committee a framework for the more strategic decisions in the portfolio.

To make the matter even more complicated and putting the utility of either mean variance optimization or Monte Carlo simulation derived structures in even sharper distinction as a mere guide, it is our firm belief that implementation can provide a significant increment of value to a portfolio's returns. Our view is at odds with conventional wisdom that asset allocation defines over 90% of the difference of returns among institutions—a view based on a study of domestic pension funds in the 1980's that used only domestic stocks, domestic bonds and cash equivalents. We believe that asset categories or even subcategories can only approximate projected returns and that manager/portfolio selection can add or detract significant value. For example, the annualized return of the S&P 500 for the five years ended June 30, 2005 was minus 2.39%, the Russell 2000 Index plus 5.75%. The spread of returns among skill-based strategies of the type found at hedge funds or private equity investment firms is even greater for nominally similar strategies. Having expressed our view of the value that managers can add, we do not simply advocate hiring a group of very smart managers and letting them invest wherever they choose. *We believe that an equity centric portfolio with allocations to streams of returns less dependent upon the course of either private or public equity returns, such as opportunistic global fixed income strategies, as well as others that we can discuss, can deliver satisfactory long-term results in a well diversified, prudently invested endowment.*

The Question of Risk

We have addressed the question of risk in terms of standard deviation of returns, but that is clearly not the only risk to the endowment assets. Risk can be defined for endowments absolutely and relatively and should certainly accommodate considerations of short and longer-term financial demands of the institution. Risks may include, but are not limited to the following: the loss of principal value and its attendant impact on spending or distributions, shortfall in expected gifts, the failure to provide a short or longer term store of value to meet financial needs, or investment performance shortfall relative to peer institutions. Typically, endowments have viewed their investment objective relative to their distribution requirements and have structured a policy to provide current distributions while preserving the purchasing power of principal in perpetuity. Many endowment boards have adopted what they intended to be long-term asset structures, only to regret them after financial market tumult and abandoning them after significant principal loss. Our goal is to determine the various risk tolerances before they are exceeded, thus reducing the chance of decisions that may lead to regret.

³ Unconstrained mean variance optimization is likely to produce asset allocation that is unacceptable to most governing boards, as it will favor those asset classes that have the best combination of return and correlation, which often excludes or minimizes the intuitively (and politically) more acceptable classes of assets that tend to dominate most portfolios. As a successful, independent Dallas investor said to me at a trustee meeting in 1990, "If we wanted conventional returns, we would have a conventional portfolio."

It is very important for us to mention our particular approach to the investment time-horizon. We produce projections of various asset allocation mixes on **one, three, five and ten year investment horizons**. Endowments are normally considered perpetual stores of value, yet most asset allocation analysis considers only one-year horizons. As one lengthens the investment horizon, the probability of generating assumed returns actually increases as the per annum standard deviation declines. It is perfectly consistent to use five and ten-year investment horizons, despite the difficulty that those who look at quarterly performance reports may have identifying with such seemingly long horizons. After all, the fund is a perpetual fund. Why then do most focus only on one year horizons? In our view it is because institutional investor practice has set the one-year horizon as the norm for asset allocation analysis, perhaps in recognition of the practical difficulty of viewing performance in a truly long-term context, despite its obvious relevance. While we are cognizant of industry norms, to us they represent an opportunity to profit from the inertia of others.

It is equally important for us to note that we use real rate of return assumptions, while most use nominal assumptions.