PART II

In Defense of the Endowment Model, Accurately Assessed

In Part I, we argued that the Endowment Model is better thought of as a set of investment principles than a recipe to be followed. Merely replicating the asset allocation of Yale's Investment Office or another leading institutional investor has always been an unlikely path to success for the average investor. Nevertheless, blaming the model for the disappointing performance of institutional funds over the last decade-and-a-half has become sport.

Richard Ennis, co-founder of consultancy EnnisKnupp and one of the loudest Endowment Model detractors, estimates that endowment-style investing now weighs down institutional fund returns by 1-2% per year.[i] He's probably not wrong, on average. The many institutions that built complex, alternatives-heavy portfolios simply because it was "*de rigueur* to do so" have likely destroyed value. Active management in any form is, for the most part, doomed in aggregate.

But that's not the whole story:

1. The post-GFC phase of the cycle has been a historically challenging one for diversified portfolios;
2. the performance comparisons concocted by those attempting to undermine endowment returns are largely flawed and misguided; and
3. we believe there are better and more thoughtful means of assessing an investment program's long-term success.

The Long View

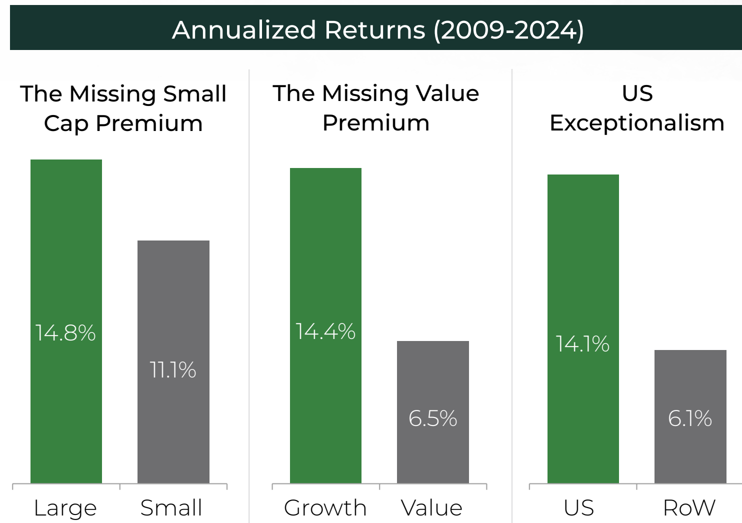
from the desk of Matt Bank
Deputy CIO

Historic Headwinds

If, as Ennis says, the ten years ended 2007 were the "heyday" for endowment investing, then the last ten to fifteen have been the heyday for *simplistic* investing.[II] We've just experienced a raging bull market in "passive," broadly defined. There are a lot of reasons for that, but muted inflation, low interest rates, and low volatility all supported ever-rising valuation multiples, rewarding risk taking.

The simpler the portfolio construction the better. Any form of diversification away from capitalization-weighted US stock indexes was a drag on returns. Traditional diversifying assets like real estate and commodities lagged equities. And within the equity market, the supposed small cap premium disappeared, the "value" premium disappeared, and international stocks barely budged while six US companies crossed $1 trillion of market cap.

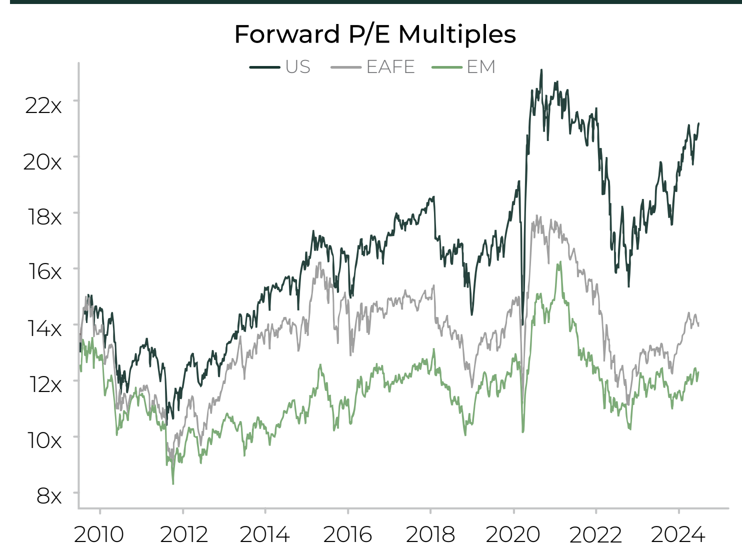
There have been other periods like this in history—the 1950s postwar boom, and the 1990s that ended with the dotcom bubble, for example—but rarely were they as consistent or dramatic.



Source: Bloomberg and Infinity. Large is S&P 500, Small is Russell 2000, Growth is MSCI ACWI Growth, Value is MSCI ACWI Value, US is MSCI USA, RoW is MSCI ACWI ex-US. Includes data from 6/30/2009 through 6/30/2024.

Dispersion across alternative investment managers—a necessary (but not sufficient) condition for alpha generation—remained high, but against conventional forms of cheap beta, it was hard to keep up.[1] In a spirited defense of endowment investing, Larry Siegel describes the post-GFC environment for endowments as like "racing Secretariat." [III]

Things will almost certainly change, and there's no reason to believe cycles are dead. Fiduciaries of perpetual portfolios should understand the antecedent factors that made the past the past, but not necessarily the prologue. More inflation volatility, normalized interest rates, shifts in geopolitics, the fiscal impulse, and a distinct constellation of valuation inputs likely mean we're in a different phase moving forward. The market's wheel doesn't turn on time scales that comport with the average Investment Committee agenda, but that doesn't mean the wheel has stopped turning. Any shift in or calming of the beta winds may again reveal the importance of alpha generation.



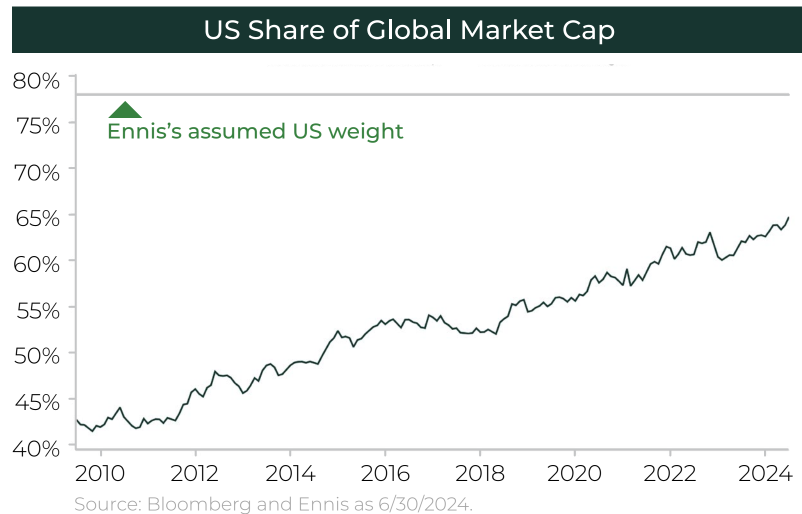
Source: Infinity and Bloomberg as 6/27/2024.

[1] Even median segments of certain alternative asset classes did manage to keep up and deliver excess returns: e.g., venture capital and smaller sub-segments of the buyout market.

Clever Comparisons

Many of the detractors of endowment-style investing do not benchmark portfolios correctly, typically relying on a simple stock/bond mix, often with a higher weight to equity than is justified. In his analysis, Ennis further assumes an average weight to US stocks of ~78% within the equity allocation[IV]—much higher than the US' share of global market cap today (65%), and certainly higher than the average since 2010 (53%). Assuming in the benchmark a big allocation to the best performing asset has predictable consequences, overwhelming the more nuanced construction of better diversified endowments.

For the largest endowments, in an effort to prove skill doesn't exist *anywhere*, Ennis assigns an "effective equity allocation" based on published asset allocation. For example, he pins Duke University's endowment as having an effective equity allocation of 97% and then benchmarks Duke's performance to that.[V] While the largest endowments undoubtedly take more equity risk across their portfolios than their smaller peers, that's been an evolution for most, and we know with certainty that 97% is too high.[2]



Source: Bloomberg and Ennis as 6/30/2024.

It's critical to get the components of the benchmark correct by matching the risk posture and profile of the underlying assets in the portfolio; otherwise, it is apples against oranges.

Resulting on Risk

Frustratingly absent from much of the debate on endowment performance is that any backward-looking analysis is almost always grounded in the cognitive bias of "resulting," or judging the merits of a decision entirely by its outcome. It's one thing to say the average endowment's performance has been worse than a simple portfolio of stocks and bonds. As described above, the post-GFC period has been a historic one for cap-weighted passive indexes. And maybe we all should have seen that large cap tech companies would grow to the stratosphere, driving indexes to historic levels of concentration, and creating a very high bar for sufficient alpha generation anywhere else. But the legendary cognitive psychologist Amos Tversky kept a piece of paper on his desk reminding him that "Man is a deterministic device thrown into a probabilistic universe." [VI] Just because something occurs doesn't tell you anything about its *ex ante* probability of occurring. In other words, endowment fiduciaries don't have the luxury of hindsight—they have budgets and faculty and scholarships and perpetual missions, so their portfolios must be constructed for a wide range of possible future states, most of which by definition won't come to pass.

[2] We suspect Ennis knows this too. His own data on 41 individual large endowments implies a negative correlation between effective equity allocation and excess return. What's more likely: that the more equity-heavy institutions have less skill than those with lower equity exposure, or that Ennis' calculation of effective equity is biased somehow, assigning too much effective equity risk to assets that don't deserve it or haven't behaved that way?

A Better Way

Proper assessment of investment offices and endowment programs must be clear and sufficiently nuanced. It requires insight and effort in addition to spreadsheets. We suggest a few better practices for fiduciaries:

1. **Ask the right questions.** There is no single metric that conclusively addresses the question of success or failure. As we noted above, even long-term returns tell you very little about the risk incurred to earn them. On the other hand, while volatility matters for endowments, conventional risk-adjusted measures like Sharpe ratios don't account for (or are distorted by) other relevant dimensions of portfolio risk like illiquidity and tracking error.

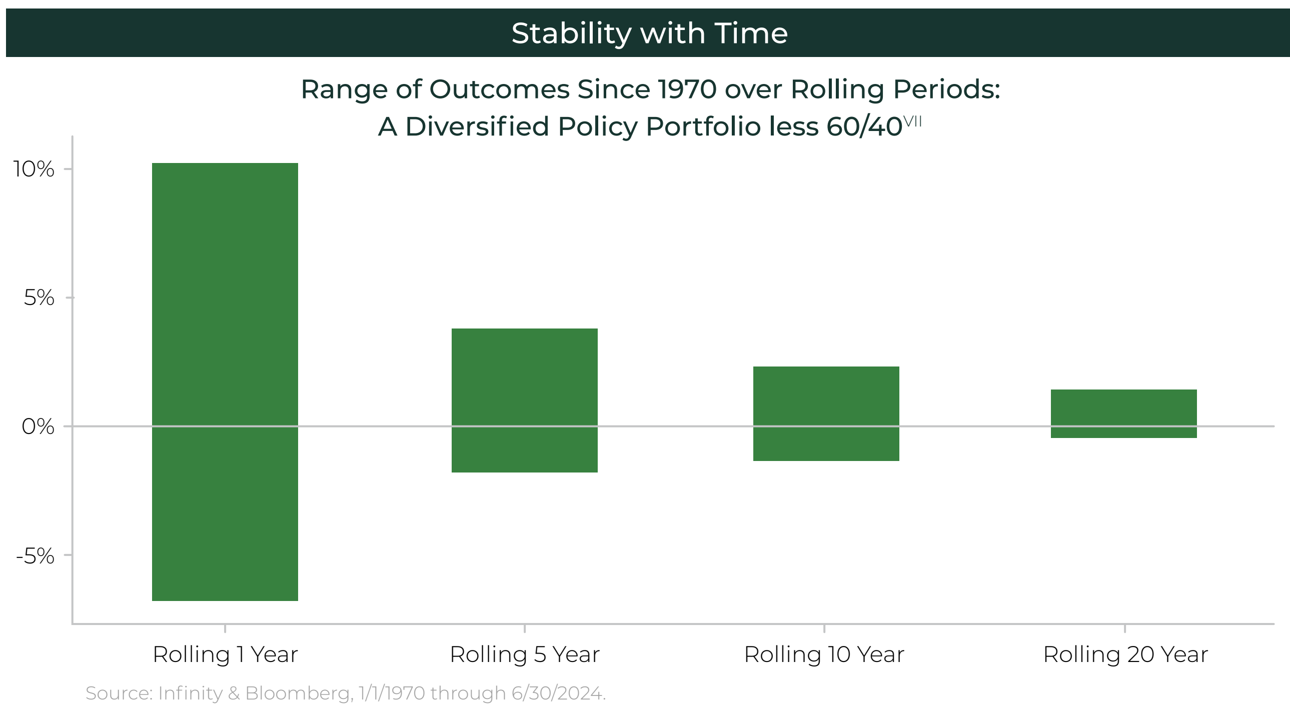
We advise clients that results relative to a benchmark should answer a single, specific question:

- **Relative to an absolute goal (say, 5% plus inflation):** Has the portfolio delivered returns at least equal to its cost of capital? In other words, has it done what it needs to do to support the institution's mission? In the endowment context, that would be delivering a sufficient return to maintain purchasing power net of portfolio draws. Ultimately, this is the cardinal objective, ranking first among equals.

- **Relative to a passive reference portfolio:** Has the portfolio's active management— the combination of asset class tilts, manager selection, and underlying security selection—added value relative to a low-cost alternative reflecting the opportunity set? There are plenty of ways to do this, but we prefer a true cost-of-capital comparison in the form of a liquid, investable benchmark with components and weights reflecting the portfolio's underlying economic exposures. Anything else in the portfolio benchmark (e.g., private capital indexes or hedge fund indexes or Treasury Bills plus 3%) creates an imaginary return stream, muddying the evaluation of active management by implying a fixed form of active management and a baseline level of competence. Don't bake into the primary benchmark the tools of active management. Evaluate their use in aggregate against the true opportunity cost. Constituent benchmarks should also be broad in nature: the MSCI All Country World Index for equity, Bloomberg Commodity Index for commodities, etc. As Siegel argued in *Benchmarks and Investment Management*, assigning weights to any incremental refinement beyond the broadest opportunity set (e.g., the outmoded style/geographic boxes of US large cap stocks, US small cap stocks, developed international stocks, emerging market stocks, etc.) begins to look like active management itself. Plus, most of these subcategories are false forms of diversification anyway, with correlations far too high in periods of market distress when the diversification is most needed to justify distinct benchmark allocations.

- **Relative to industry benchmarks:** Within each asset class or strategy utilized, have we selected managers effectively from the opportunity set? This is where we introduce uninvestable industry benchmarks—the Credit Suisse Hedge Fund Index, Burgiss data for private investment results, etc.—to measure our selection skill against quartiles, and to determine where portfolio out- or underperformance is coming from. The caveat is that these must be well understood and handled with care as these industry databases can often lack breadth or be poor proxies for manager opportunity sets. But they're necessary means for gauging success.

2. Give it time. There will be almost no short- or medium-term horizon over which any endowment is clearing all benchmarks at once, and there may be frustratingly long periods when portfolios don't even clear a plurality of them. That doesn't mean it's time to replace the team and pivot to a 60/40 portfolio. As quant investors would say, endowment portfolio returns offer a low signal-to-noise ratio. In the end, a fiduciary's responsibility is to disentangle skill and luck, and that can't be done without the benefit of time. We generally view 10 years as a minimum period for gleaning legitimate insight from performance data, but even that depends on the duration of the economic and market cycle and is still highly sensitive to start- and endpoints. We once saw an Investment Policy Statement that declared that the portfolio's results would be evaluated over "a full cycle: rolling 1, 3, and 5 years." That's akin to re-judging a thousand-meter race every hundred meters.



Source: Infinity & Bloomberg, 1/1/1970 through 6/30/2024.

3. Don't move the goal posts. We are often asked during bull markets why endowment portfolios aren't keeping up with high-performing equity markets or the vastly different peer institution up the road. The answer, of course, is because they aren't supposed to. They are supposed to provide sufficient growth to deliver a stable draw through cycles, in a precise manner tailored to an institution's goals. Ensuring consistency in the benchmarking process, allowing the vagaries of market noise and volatility and the variation in public and private asset return patterns to flow through the figures, and remembering what the capital is for—to what ends it is deployed and the consequences of poor stewardship—is a critical governance ethic. Some institutions can tolerate more illiquidity, others more equity, others more tracking error. Others can tolerate less of all three. Documenting—both initially and on an ongoing basis—the reasons for committee decisions, the expected outcomes of those decisions, and the circumstances under which they may not work, is a useful discipline and affords future committee members insight and institutional knowledge.

4. Focus on inputs. Because performance outputs are either a red herring or a lagging indicator, evaluating the *inputs* to performance is more useful. From our perch monitoring our stable of managers, we continuously look to help ensure that a well-defined investment philosophy affords them a discernible and persistent edge over relevant competition sufficient to justify the fees.

For endowment fiduciaries, it is no different. Over-indexing to the numbers can distract from important markers of good future results. Disciplined asset allocation, intensive manager sourcing, robust due diligence, sound decision-making, team collaboration, good governance—those are just some of the inputs required for the outcomes most endowments are seeking.

To test for those, Investment Committees should continuously ask, and document their answers to, some mix of the following:[VIII]

- What approach to portfolio management do we believe will work?
- What capabilities does our investment team need to execute that approach effectively?
- Is the portfolio arrayed appropriately for our organizational goals and constraints?
- Do we understand who is accountable and is the decision-making process sound?
- Is the rationale for specific actions taken or not taken both thorough and rigorous?
- Does the team take in and process information in an effective manner?
- Is the team properly incentivized? Or do they have outside shareholders looking over their shoulders?
- How does the team address and learn from inevitable mistakes?
- Do they have mechanisms for and a culture of risk management?
- Does the team exhibit integrity in all respects?

Whether a team is running a passive, low-cost portfolio, or an active, complex one, the questions will differ, but the point is that there are important assessments far beyond the numbers, and we have observed that the best Investment Committees spend the bulk of their time on these issues. Only with constant cogitation on leading indicators can a fiduciary make informed judgments about the probability of a portfolio's prospective success or failure.

Conclusion

Endowment-style investing is costly and complex. Manager sourcing, access demands, and limits to scalability are too much for many consultants and large allocators to overcome net of all fees and costs. On that score, Ennis is right.[3]

But that doesn't mean the approach has failed or is doomed to do so. The post-GFC environment has been a particularly challenging one for endowments large and small. It was beta-driven and supported by rising valuations and limited market breadth. There were long stretches during which real bond yields were negative. There's no reason to extrapolate those as now-permanent features of markets. As the cycle turns, the quality as opposed to the simplicity of a portfolio should once again become paramount.

For those competent and capable, we believe the endowment style continues to work just fine. But fiduciaries need a better framework for evaluating success or failure than the constructs offered by Ennis and other detractors. Using inappropriate benchmarks, or moving the goalposts, or resulting on outputs, are surefire ways to undermine an institution's mission and destroy capital. At some point during a market cycle, almost every investment strategy has its day in the sun while others look foolish. **But history has shown that investing today in what you should have invested in yesterday is reliably unproductive.**

Fiduciaries should focus on evaluating the substance of their investment offices. If the institution invests in an endowment style, does the team have a path to win in a hypercompetitive environment? Do they have the right attributes to execute effectively? What are those attributes? We'll explore these in Part III.

Matt Bank
Deputy CIO, GEM

PART III

In Defense of the Endowment Model, Effectively Executed

In the final piece of this series we will explore the attributes required to effectively invest an endowment-style portfolio over the next decade.

[3] His antidote—passive investing—is not without its own peril, since passive portfolios are not priced today to deliver returns that meet the liabilities of most large pools of capital.

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ENDNOTES

[I] Richard M. Ennis, Excellence Gone Missing, May 12, 2023.

[II] Richard M. Ennis, Have Alternative Investments Helped or Hurt?, August 3, 2023.

[III] Laurence B. Siegel, Don't Give Up the Ship: The Future of the Endowment Model, The Journal of Portfolio Management, Investment Models 2021, volume 47, issue 5, February 2021.

[IV] Richard M. Ennis, Failure of the Endowment Model, November 26, 2020.

[V] Richard M. Ennis, Unexceptional Endowment Performance, April 7, 2024.

[VI] Michael Lewis, The Undoing Project: A Friendship That Changed Our Minds, 2016.

[VII] Diversified Policy Portfolio represents an illustrative, factor-based portfolio that results from investing in each respective underlying factor benchmark at a stated target as noted in the table below. The portfolio shown represents GEM's opinion of how a Diversified Policy Portfolio may be constructed based on GEM's analysis, assumptions, and data interpretations; it should not be relied on as fact. 60/40 represents 60% MSCI ACWI / 40% Barclays Aggregate Bond Index.

Return Factor	Illustrative Target	Benchmark
Equity	53%	MSCI ACWI
Credit	7%	Bloomberg High Yield Index
Commodities	3%	Bloomberg Commodity Index
REITs	12%	MSCI US REIT Index (gross)
Treasuries	15%	Bloomberg US Treasury Index
TIPs	10%	Bloomberg US Tsy Inflation Notes Index

[VIII] Questions loosely adapted from Greenwich Roundtable's "Best Governance Practices for Investment Committees", 2014.

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