PART III

# In Defense of the Endowment Model, Effectively Executed

In **Part I** of this series on the Endowment Model, we discussed the problems with characterizing the model in static, monolithic terms, arguing for a more flexible and nuanced definition.

In **Part II**, we described some of the flaws in conventional ways that endowment portfolios are measured and evaluated, proposing instead a distinct set of guidelines for determining success.

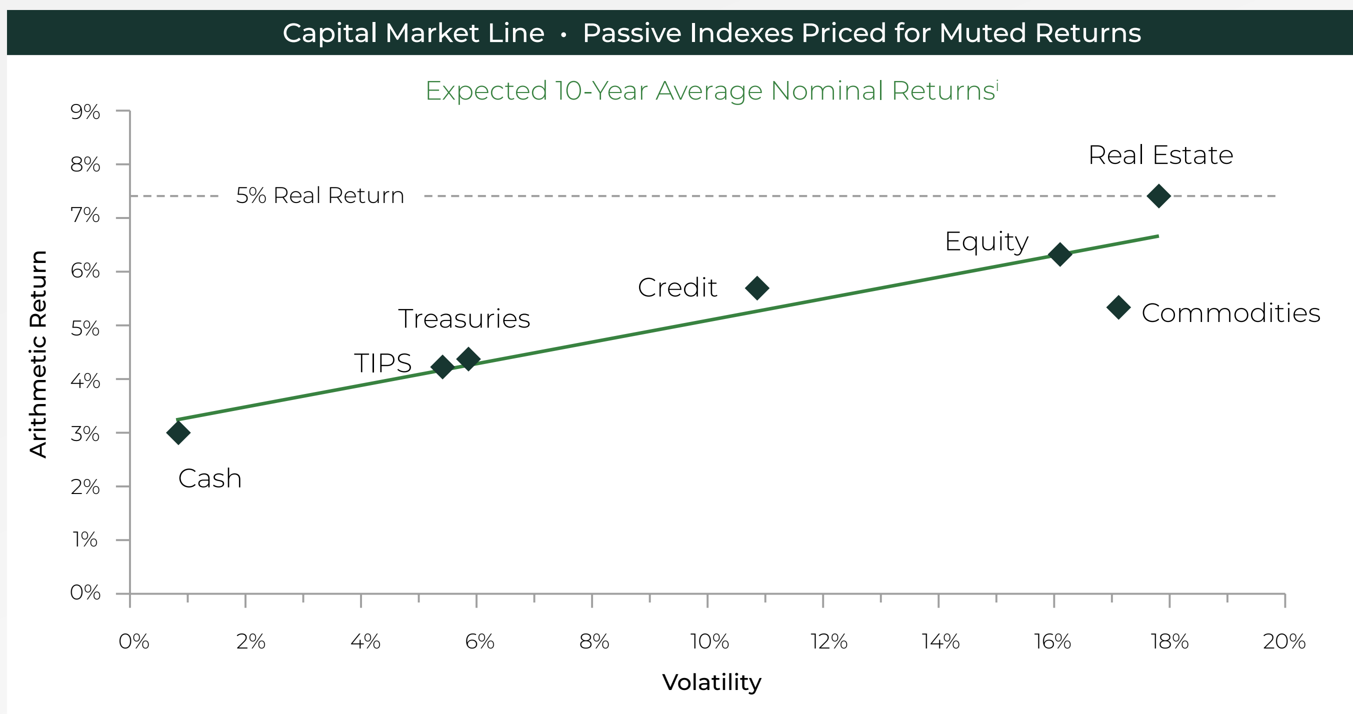
In this final **Part III**, we discuss what it will likely take—the necessary skills, attributes, and character—to be successful over the next decade investing endowment-style portfolios. Even as markets become more competitive every day, good investing is never commoditized. Instead, we believe that a combination of institutionally-driven portfolio construction, manager sourcing intensity, process efficiency, and organizational alignment is a clear path to differentiated success.

## The Long View

from the desk of Matt Bank
Deputy CIO

A former colleague once suggested that every investment organization exists somewhere on the spectrum between treating investing as a business and treating it as a profession. The hard fact is that much of the current institutional investment arena, and the teams operating within it, are built for something other than excellence. They're built for distribution, for product development, for scale, or for shareholder value. Even the in-house investment offices of pensions, non-profits, and other institutional allocators can have polluted incentives, influenced by career risks, flawed compensation schemes, political wrangling, or bureaucracy.

As portfolio performance is concerned, that's been mostly fine over the last decade-plus. Bull markets can render harmless a lot of suboptimality. But going forward, *fine* may not cut it. As the cycle evolves, as volatility re-emerges, as the firehose of capital continues to point toward alternative investments, and with many firms' capital market assumptions (including GEM's) implying that passive indexes are priced for muted returns, investors need to be very clear about and confident in their plan.




Source: Bloomberg and GEM analysis.

"Good investing matters most when markets offer the least," AQR's Antii Ilmanen wrote in his book *Investing Amid Low Expected Returns*. I've borrowed that line at least a half dozen times because it so effectively captures the challenge. It's unlikely fiduciaries can continue to count on the Lake Wobegon era of capital deployment—wherein all the strategies are successful and all the managers above average.

## What, then, are those deploying endowed capital to do?

# 1. Run your own race.

The institutional investment community should quiet the impulse of peer-chasing circularity that pulls Boards and fiduciaries away from sensible, institutionally-integrated portfolio construction.

Every endowed portfolio should be aligned with the organization's specific set of objectives and constraints. The stream of liabilities—weighed against budget reliance, operating health, cash flows, spending rates and spending variability, and balance sheet strengths and fragilities—should drive strategic allocation decisions. All too often, we have observed the contours of an organization's needs (both current and future) are ignored in favor of convention. It's hard to deviate from the safety of a herd, especially for Board members with a variety of stakeholders looking over their collective shoulder. But without a willingness to incorporate distinct inputs and map them to an appropriate portfolio taxonomy and asset allocation, you're risking harm to the organization.

Moreover, the exercise of portfolio management is no longer simply about investment policy design and implementation. Most clients that we serve today need an "everything partnership"—something far more holistic. We're working right now to support a university through a period of overspending brought on by declining enrollment. We're working with a foundation on advancement strategy and engagement with donors. We're supporting an independent school in its decisions about a possible bond repayment. We're working with a health system to prepare for some critical strategic outlays for service and facility expansion. In a period of disruption for non-profits of all stripes, these should be core functions of the investment office.

**The best investment offices, in our view, always maintain an unwavering focus on serving the client's mission.**

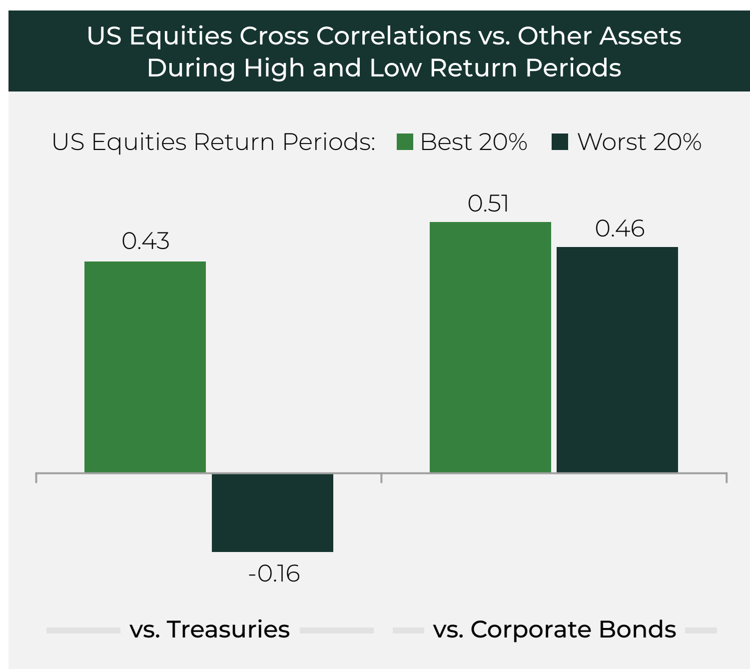
# 2. Insist on efficient diversification.

Endowment portfolios are often criticized for excessive diversification along practically every dimension—number of asset categories, number of managers, number of holdings, etc.

Excessive diversification takes many forms. There's the functional form: the incremental equity manager that provides an overlapping style and sector mix with another, the private resources investment that contributes a risk correlated with some other holding, or the next hedge fund manager that satisfies a target allocation to hedge funds without regard to whether it represents the optimal use of that marginal dollar. There are also various forms of expense: the cost of team resources to monitor managers and holdings, or the "netting drag" that comes from incentive fees being paid to different, volatile managers at different times.

Make no mistake, we are big advocates of diversification, extending across styles, sectors, geographies, factors, managers, securities, currencies, and other dimensions. But that complexity does come with a cost, undoubtedly straining investment teams and risk managers. Teams should be certain of the role each investment serves, how it contributes to or correlates with fundamental forms of risk, and why the allocations are sized the way they are. Insights from manager data and exposure management tools are critical. Investors need to be able to see whole portfolios transparently, leverage risk models effectively, examine exposures through different lenses, test distinct allocation scenarios, and distill outputs for communication with Boards. Most portfolios likely *could* be more efficiently managed, with the theoretical goal that no excess capital is steered toward some dimension of diversification that could otherwise be steered toward driving total returns.

At GEM, we utilize a factor framework at the total portfolio level that allows us to look through an investment strategy or structure to the fundamental economic risks that it contributes to the portfolio. These are often referred to as "return streams," which should be discrete, and as simple as possible. For example, investment grade bonds are not a distinct risk factor within our framework because their correlation to equities in both good equity environments and poor ones tends to be roughly the same. The credit component of investment grade fixed income tends to dominate in bad equity markets, and the interest rate component tends to dominate in good equity markets. *Not so helpful from a diversification perspective.* Treasuries, on the other hand, have a solidly negative correlation in down equity markets because they reflect pure interest rate risk.



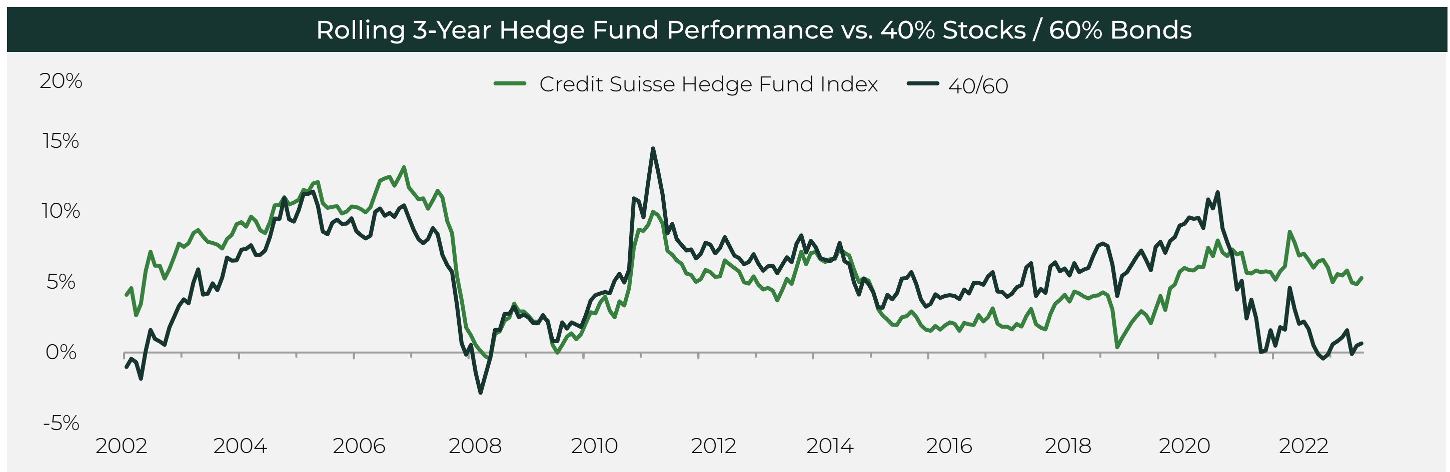

Source: Datastream and S&P 500 Total Return Index, 1998-2022.

We also work to help ensure diversification is efficient at the asset class level. Within Public Equity, we monitor all manager correlations against one another, and assess their underlying equity positions, leveraging risk models to measure style, sector, and geographic exposure, as well as expected portfolio tracking error.[ii] When we utilize overlays to adjust portfolio exposure, we typically test a range of options to help ensure the least amount of capital has the biggest impact on overall exposure.

3.

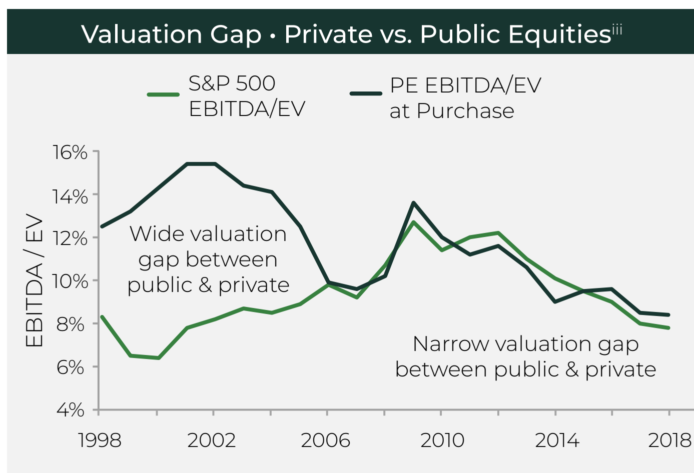
# Maintain a high bar for active management.

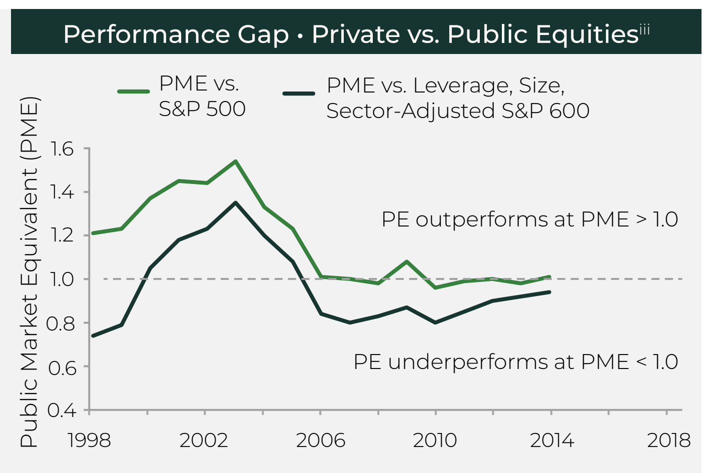
Long ago, the average alternative investment used to be good enough to deliver alpha. Not so anymore. The Credit Suisse Hedge Fund Index, a proxy for hedge fund industry returns, reliably underperformed (until very recently) a passive 40% global stock / 60% bond portfolio for most of the post-Global Financial Crisis era.




Source: Bloomberg and GEM analysis as of 6/30/2024. 40/60 is 40% MSCI ACWI / 60% Bloomberg US Agg.

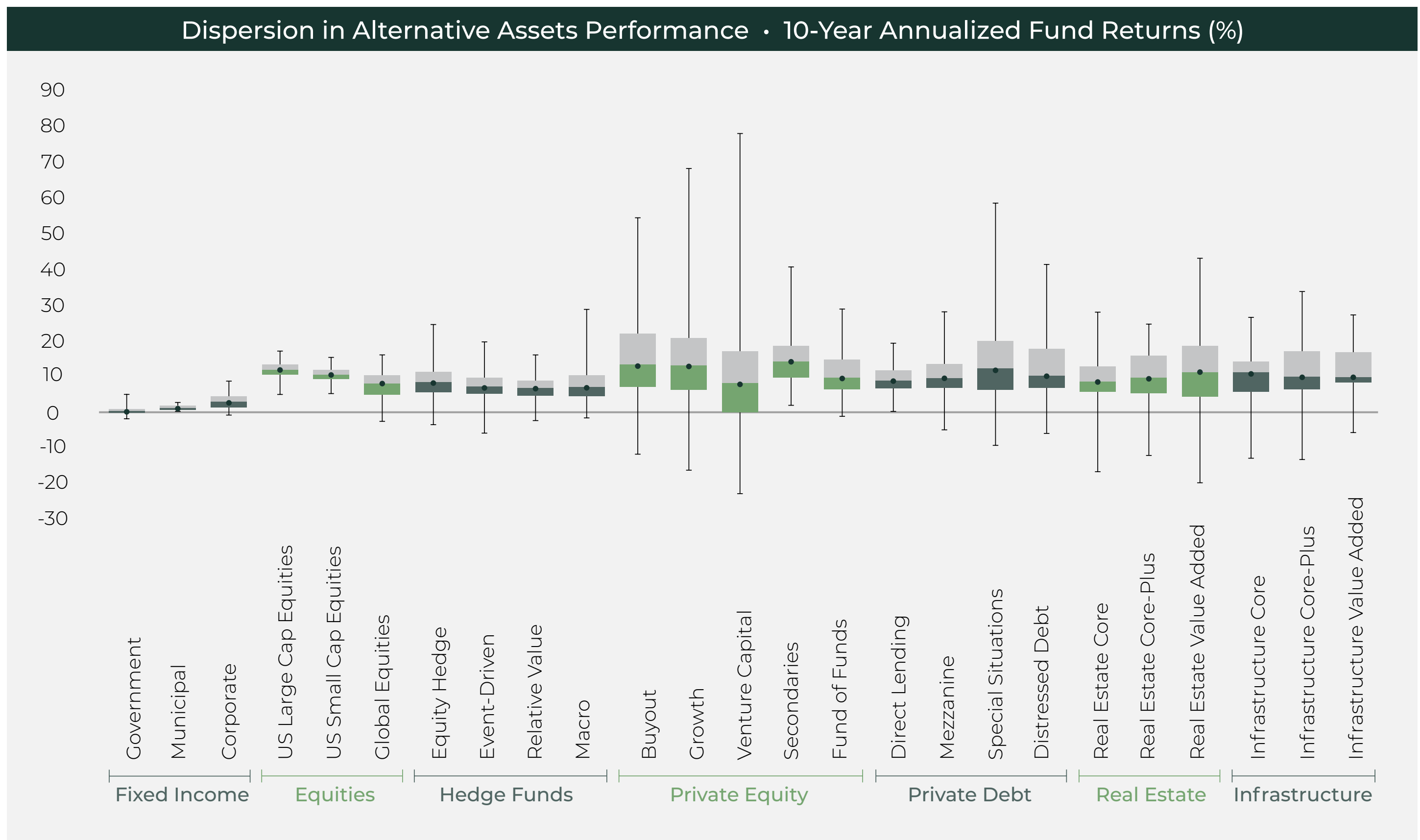
Similarly, any notion of an "illiquidity premium"—to the extent it ever existed—is almost certainly gone now. When valuations on private assets caught up to those of public assets around 2006—*surprise, surprise*—the return advantage for the average private investment collapsed.




Source: Journal of Alternative Investments.

In alternative markets, there's no prize for playing. The enthusiastic adoption and institutionalization of these asset categories has turned the alphas of the past into betas of the present and future. That doesn't mean hedge funds and private equity aren't attractive opportunity sets from which to source investments—they are, because dispersion remains high. Allocators just need to select effectively, leveraging networks and process to access best-in-class opportunities with the highest potential returns.




Source: CAIS, Performance Dispersion in Alternative Asset Classes, November 18, 2022. See CAIS website for relevant disclosures.

"Best-in-class" *looks* different now than it did twenty years ago, too. In buyouts, for example, the best returns have generally come from small funds.[iv] That's well understood. To establish relationships with small buyout managers we believe have the most potential, GEM invests early—often engaging with talented sponsors on a deal-by-deal basis prior to a committed fundraise. This approach is not for tourists. The demands on sourcing and underwriting are extensive, but "access" is increasingly about scouting and backing elite talent early. Once a manager's skill is obvious to the market, it's either too late for the average investor (the manager is closed), or it's not attractive (the manager is *very* open and raising too much capital).

Venture capital is going through a process of institutionalization as well, catalyzed by the Covid-era capital surge. The base rate for venture is already daunting—nearly 60% of venture funds raised lose value.[v] Many of the great brands of old are raising gobs of money and making the mountain higher. By outgrowing the opportunity set and building asset managers with multiple product lines and fund families, we believe that they will be increasingly burdened by the distractions of scale.

We remain confident in the merits of backing innovative early-stage companies, and in the opportunity for venture capitalists to own an ever-larger share of generational companies. But finding managers that have the networks and brand to secure sufficiently large ownership stakes in those important companies, and that are deploying appropriate amounts of capital such that those important companies support impressive fund returns, is critical. That search requires a robust and proactive sourcing apparatus. For investment offices, that means having people capable of disciplined prioritization, who can turn over nearly every stone, build the office's brand in key practice areas, and develop and deepen networks. Teams need structuring know-how, a reputation for sophistication and candor, and a compelling value proposition of partnership to talented GPs. The outmoded, reactive model of manager engagement can populate a portfolio, but it cannot ensure you're seeing the best ideas.

# 4. Cultivate a culture.

In our experience, the single most important predictor of investment office success is team culture. There are a number of virtues to foster:

- **A commitment to quality:** There can be no excuses for why something doesn't measure up to a standard of excellence.
- **Continuous improvement:** A voracious curiosity for learning and exploring new areas. When things don't work, admitting—even embracing—mistakes, and then addressing and learning from them.
- **Alignment:** A team should drive toward a single, cohesive goal rather than the goals of their sub-team or outsiders, and incentives should be calibrated with long-term portfolio goals and objectives.
- **Collaboration:** Multi-asset portfolio management is the ultimate team sport. If the goal is an integrated portfolio, you can't have teams operating in silos. The information pipes must be open with insights flowing freely, all in pursuit of truth rather than credit.
- **A principal mindset:** The team must be empowered to pursue ideas and make decisions with autonomy. That demands a governance structure that supports freedom of action. Investment opportunities often move quickly, and having to defend or justify every decision to layers of committee bureaucracy impairs results and saps motivation. If the person primarily responsible for stewarding your organization's portfolio has a boss who has a boss who has a boss who has a boss, chances are they will behave as an agent, concerned with things other than just investment results.
- **High energy:** Energy is contagious, and high-competition environments require extreme hustle. For manager-driven portfolios predicated on access, everyone should be out on the road, living out of suitcases and in hotel rooms, building relationships. There just aren't any shortcuts to burning shoe leather.

# 5. Hone the organization.

Organizational design—aligning all of the investment office's elements with the investment strategy—is critical. That entails asking the right questions:

- **Are assets and team appropriately scaled?** For what we do and where we excel, GEM could not succeed with $100 billion of assets under management. In our opinion, that bumps up against the physical limits of efficient capital deployment. But likewise, we couldn't be $3 billion in size, where our resources and ability to drive our own opportunities would be inadequate. We couldn't execute effectively with 400 people sprawled across seven global offices, nor could we do it with four people in a single office. Size and scope must be consistent with the team's strategy.
- **Have you prioritized recruiting and retaining people with the right skill sets?** Everyone wants "A players," but their experience and capabilities vary widely. Do you want to run a robust co-investment or direct investment program? You need people with the experience to execute that well. Do you want to build an internal public markets-focused team? You'd better be sure you have the incentive system properly aligned. You go to war with the army you have, as the saying goes, but strategically building that investment army to serve your approach and goals is essential.
- **Do the institutions you serve share your investment horizon?** Much of the year-to-year drama in endowment performance is attributable to institutions that have long horizons behaving as if they have short ones. Achieving long-term alignment starts with good governance. Minimizing disorderly committee turnover, ensuring that a strong committee Chair can positively influence behavioral norms, and clearly codifying the responsibilities of each stakeholder in the process—from policy setting to implementation—are all conventional concepts but of elevated importance moving forward.
- **Have you solved for leadership and succession? Who will run the investment team and firm for the next decade or two?** Many of the best investment offices have enjoyed uncommon continuity in leadership. Of course, those two things—success and continuity—are self-reinforcing (success begets continuity just as continuity begets success). Counter to this observation, an increasing number of GEM's OCIO peers have decided to sell themselves to private equity, to large asset management complexes, or to wealth management aggregators. The business logic of that makes sense, and bully for the owners capturing the enterprise value. But it's not clear to us the *investment* logic of those combinations: how they help those teams deliver better results and service to clients. We have carefully crafted our succession plan to help ensure we're positioned for success in the next decade and beyond.

# Conclusion

It's easy to nitpick the Endowment Model: Take a narrow view over a limited timeframe during which the headwinds to diversification and active management have blown at a Category 4, conflate poor execution with failed principles, and you can no doubt paint a picture of value destruction.

But the critique is superficial. In this era of renewed market, economic, and geopolitical volatility, we'll need strong and secure educational and civic institutions more than ever. Whether you invest in the endowment-style or not, now is likely not the time to shop for a new framework. It's the time to ensure that whatever framework you employ is appropriate for your organization and your team. None of the Endowment Model, the "Total Portfolio Approach," the "Canadian Model," or any alternative, is a prescriptive, off-the-shelf investment solution. Each is a means of organizing team and Board governance around a mindset, a particular set of capabilities, and a style of active management.

For institutions that will measure their performance not just in quarters but also in decades, we believe endowment-style investing still holds immense promise in the right hands. And over the next decade, the important innovations are not likely to be about the framework at all, but about execution. In GEM's view, the crucial developments will relate to how an investment office designs its team and process to unlock the best of its abilities. How it runs its own race. How it insists on effective diversification. How it clears a high bar for active management. How it cultivates a culture. And how it hones its organization in alignment.

Endowment-style investing takes skill and dedication, patience and perspective. But when rightly understood, accurately assessed, and effectively executed, it can deliver, today and into the future.

**Matt Bank**
Deputy CIO, GEM

PART I

**In Defense of the Endowment Model, Rightly Understood**

In the first piece of the series, we reaffirm GEM's belief that the Endowment Model – in the right hands, for the right institutions – remains a compelling means of achieving risk-adjusted returns.

PART II

**In Defense of the Endowment Model, Accurately Assessed**

In Part II of this three-part series, we tackle the incomplete quantitative arguments around endowment performance and present a framework for evaluating long-term success.

## ABOUT GEM

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## ENDNOTES

[i] Depicts GEM's 10-year forward-looking Capital Market Assumptions as of 6/30/2024. Statements regarding forward-looking returns, market events, future events or other similar statements constitute only subjective views, are based on GEM's long-term capital market and alpha assumptions, expectations and beliefs, should not be relied on as fact, are subject to change due to a variety of factors including fluctuating market conditions, and involve inherent risks and uncertainties, both general and specific, many of which cannot be predicted or quantified and are beyond GEM's control. Future evidence and actual results could differ materially from those set forth in, contemplated by, or underlying these statements. In light of these risks and uncertainties, there can be no assurance that these statements are not or will prove to be accurate or complete in any way.

[ii] GEM has approximately 95% look-through into our public managers' portfolio positions.

[iii] Journal of Alternative Investments, Winter 2020 – Volume 22, Issue 3. PE EBITDA/EV from 1998 to 2008 are a proprietary dataset from Dan Rasmussen, based on data from Cambridge Associates and Capital IQ. S&P 500 EBITDA/EV is from Bloomberg. PMEs from L'Her et al. (2016). Vintage years are assigned based on the year of the first investment by a fund. PME is public market equivalent, a benchmarking methodology used to evaluate the return an investor would have obtained if they had invested in public markets instead of a private equity fund. Winter 2020 – Volume 22, Issue 3. PE EBITDA/EV from 1998 to 2008 are a proprietary dataset from Dan Rasmussen, based on data from Cambridge Associates and Capital IQ. S&P 500 EBITDA/EV is from Bloomberg. PMEs from L'Her et al. (2016). Vintage years are assigned based on the year of the first investment by a fund. PME is public market equivalent, a benchmarking methodology used to evaluate the return an investor would have obtained if they had invested in public markets instead of a private equity fund.

[iv] According to Burgiss Private iQ data as of June 30, 2023, including North American buyout funds from 1998 through 2023. Past performance is not indicative of future results.

[v] According to Burgiss Private iQ data as of September 30, 2023, including US venture capital funds from 1990 through 2019. Past performance is not indicative of future results.

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