Should Your Endowment Size Dictate Your Investment Approach?

THE ANSWER IS NO!

John W. Griffith

Director and
Endowment Specialist

JGriffith@HirtleCallaghan.com

Anne D. Ford

Director, Communications

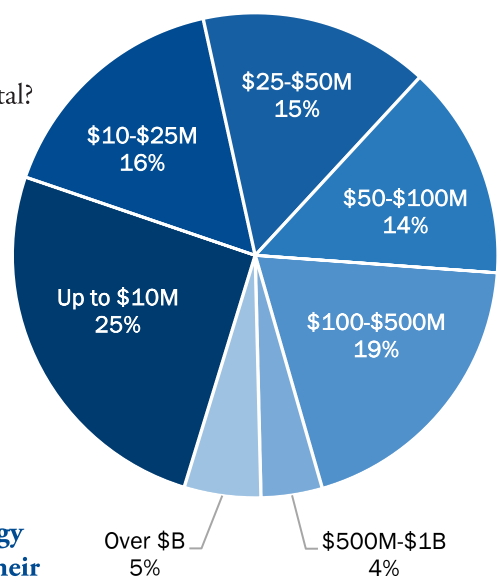
AFord@HirtleCallaghan.com

The media devotes most of its time to talking about mega endowments such as Harvard, Yale and Princeton. But what about the smaller endowments? Seventy percent of all college and university endowments are less than $100 million. How are they allocating capital? And should it differ from the larger endowments?

Our experience has been that smaller endowments manage their capital very differently – and leave additional return on the table as a result. There is a tendency to correlate small endowment size with a lower risk profile, resulting in smaller endowments generally earning subpar investment returns. This puts them at risk of compromising their long-term mission if their endowment cannot provide the necessary resources to sustain the organization.

All endowments should have an investment strategy that is designed to maximize resources based on their organization's ability to take risk, not on size.

Private College Endowment by Size



Source: 2021 NACUBO-TIAA Study of Endowments.

Why Do Smaller Endowments Pursue a Sub-optimal Strategy?

Smaller endowments on average have a 12% higher allocation to bonds than larger endowments and an 8% lower allocation to growth assets (including public and private equity). This "less risky" strategy has proven to be sub-optimal, resulting in lower returns over time. Based on data from the 2021 NACUBO study, endowments under $100 million have significantly underperformed endowments over $100 million during the past decade and especially over longer time periods of 20 and 25 years.[1]

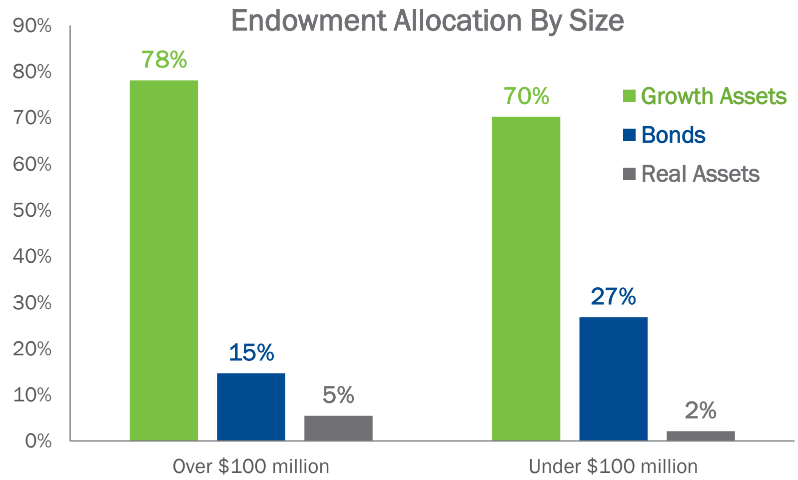
So why are smaller endowments consistently pursuing a lower-return approach and under-optimizing their endowment? We have identified three potential culprits:

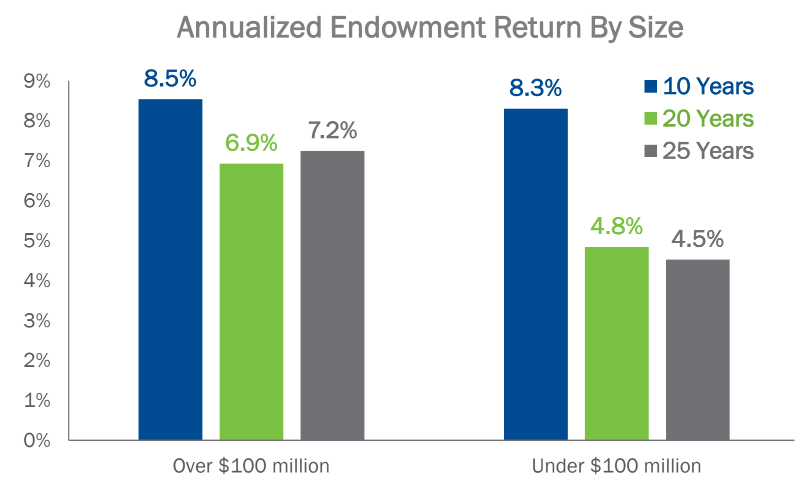
1) Lack of alignment between mission and investment allocation

2) Lack of a holistic framework to assess the organization's ability to take on risk

3) Myopic view of time horizon at odds with the perpetual nature of institutions

Let's explore how nonprofits can overcome each of these challenges and pursue a more optimal investment strategy for a normal-sized endowment.





Source: Hirtle Callaghan, 2021 NACUBO-TIAA Study of Endowments.
All data is for the period ending 6/30/2021.

[1]The NACUBO-TIAA Study of Endowments is an annual report from the National Association of College and University Business Officers and TIAA on higher education endowment and foundation investment performance and management practices. In 2021, the study reflects responses of 720 institutions representing $820 billion in endowment assets. The sample size is 575 endowments for the 10-year period, 201 endowments for the 20-year period and 133 endowments for the 25-year period.

Put Mission at the Forefront of Your Investment Objective

Investment Committees constantly balance two conflicting goals — growing the endowment over time while limiting near-term drawdowns. To help narrow in on the organization's endowment objective, it helps to start with an assumption:

All nonprofits (regardless of size) need more resources to fulfill their mission

The Investment Committee's job is to maximize the endowment's return within the parameters of the organization's risk profile. Yet, trustees of smaller endowments are often so focused on mitigating risk that they compromise the ability of the endowment to generate high returns. If investment returns perpetually fall short of covering spending plus inflation, then trustees are not doing their job as fiduciaries.

Having a clear mission-focused investment objective enables Investment Committees to build an investment program aligned with the mission. To generate enough return to support the future needs of the organization, most nonprofits with smaller endowments will need to revisit their asset allocation and the level of equity risk they can tolerate.

So how should nonprofits gauge the "right" level of risk for their endowment?

Take a Holistic View of Risk

Investment Committees should reassess how they view endowment risk and take an approach that looks holistically at organizational risk, not just market risk. Although Investment Committees generally assume having a smaller endowment means they must take lower risk, in reality the organization's financial condition is the most significant factor in determining how much endowment risk you can take. The size of your endowment is a factor, but far from the most important one. In fact, we would argue several other organizational factors are more important as you consider your endowment's asset allocation and risk parameters.[2]

Important Risk Factors

Spending: What is the current spending rate and how dependent are operations on the annual endowment distribution?

Endowment Gifts: What percentage of the annual endowment spending will be funded via endowment gifts?

Liquidity: What is the organization's liquidity profile (e.g. operating reserves, days cash on hand, line of credit?)

Operating Margin: Is the organization running at a surplus or deficit?

Revenue Mix and Trends: How diversified are your revenue streams and how dependent are they on endowment income?

Taking a holistic view, most nonprofits with smaller endowments have two key advantages enabling them to take more equity risk:

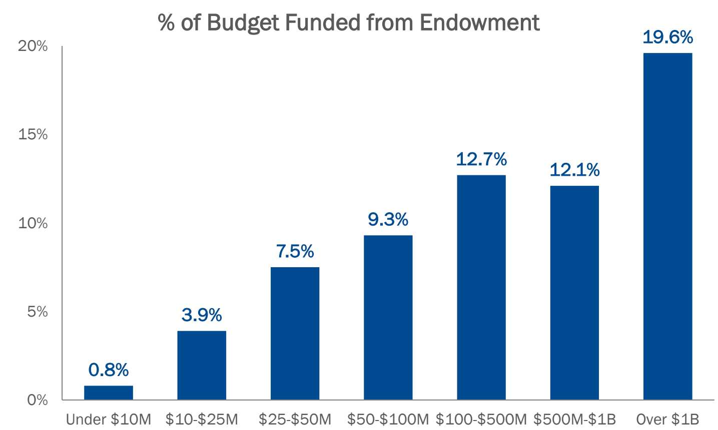
1) Endowment income funds a smaller portion of the budget, which means market volatility will have less of an impact on operations. Board members typically worry about the inherent volatility of equities and hence view them as riskier.

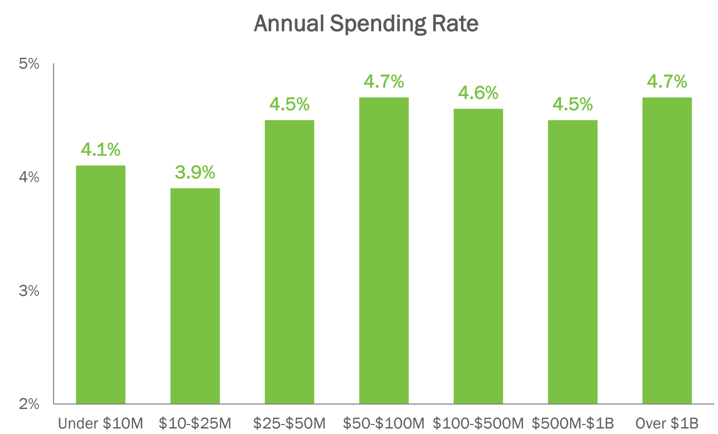
Focusing on the impact of volatility on operations, rather than simply the level of volatility, will in many cases provide more comfort with a higher equity allocation.

2) Smaller endowments have a lower spending rate, meaning they distribute less from their endowment each year. Lower spending gives the corpus of the endowment more room to grow over time and benefit from compounding.

This underscores the importance of having an asset allocation that supports endowment growth.

Ironically, we often find that organizations with low endowment dependency or a low spending rate have relatively conservative asset allocations, feeling the need to be cautious. Board members often falsely believe covering spending and inflation is sufficient; as a result, exposure to equities and expected endowment return are too low, not allowing for future growth. Their caution is misguided — the primary concern should be failure to achieve the organization's mission if the endowment's purchasing power erodes over time.





Source: 2021 NACUBO-TIAA Study of Endowments.

[2]For more detail on how higher education institutions can access their financial condition, please reach out to us for our papers on "Assessing Your College's Financial Condition" and "Why Schools Need An Operating Cushion."

Capitalize on the Endowment's Long Time Horizon

An endowment's perpetual time horizon is its greatest advantage to support the organization into the future. Yet we find trustees tend to focus on short-term risk factors when deciding on an asset allocation designed to support the organization in perpetuity. While it is certainly important to model out potential downside scenarios, in general the endowment should be viewed with a much longer-term lens.

Taking a long-term view affords trustees a different perspective on equities. Although they are inherently more volatile, over the past 30 years, U.S. equities have returned 10.6% annualized versus 5.3% for domestic bonds, an excess of 536 basis points. The asset management industry tends to report in shorter time frames, the standard being one, three, five and ten years. It is hard to maintain a focus on 30+ years when the industry conditions us to think and behave otherwise. Nevertheless, Investment Committee members need to look past this short-termism.

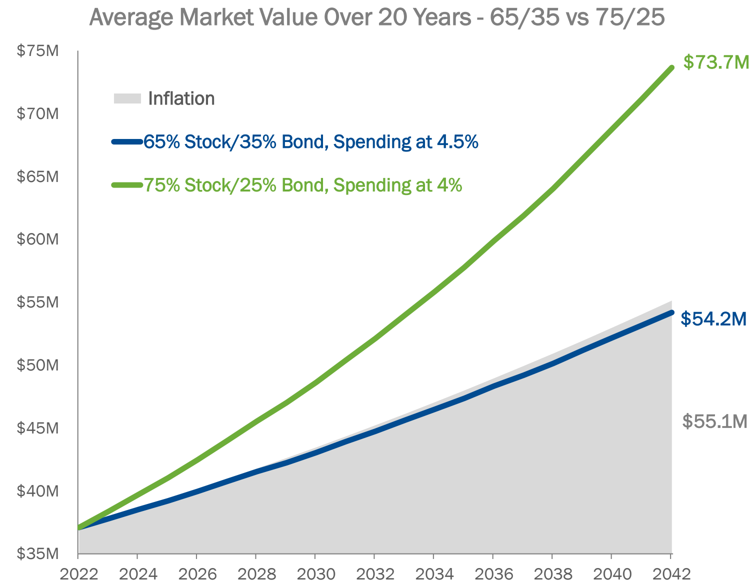
On the right we present an analysis to illustrate how the impact of a few simple changes can be significant.

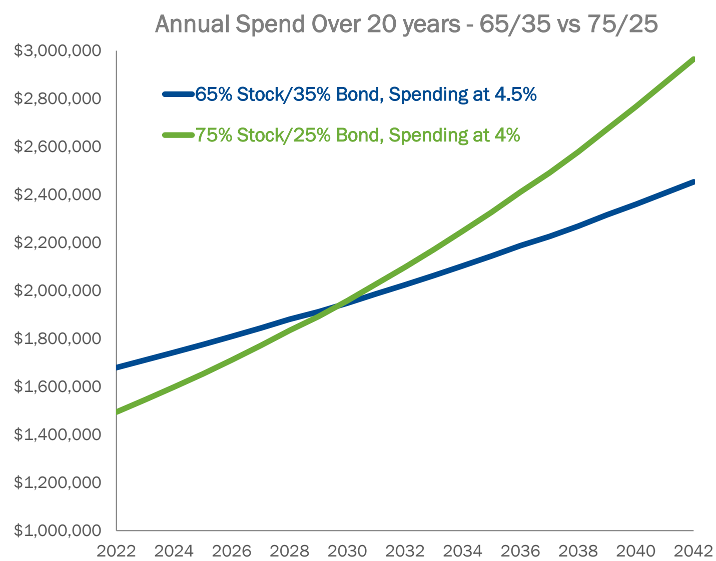
We start with the average asset allocation for small endowments—65% Equities and 35% bonds—with an endowment spending rate of 4.5%. As shown, this scenario fails to keep pace with a 2% inflation and has an expected terminal value in 20 years of $54.1 million.

Increasing the equity exposure to 75% equities and 25% bonds and lowering the endowment spending rate to 4% results in significant growth relative to the first scenario with an expected value of $73.7 million in 20 years.

Over the 20-year time horizon, the expected portfolio value is not only approximately $20 million higher, but the expected cumulative spending in the second scenario exceeds the original by $2 million even though the spending rate is lower.

Such small changes in your asset allocation and small changes in your spending can dramatically impact your organization's future. Thus, it is imperative to understand this risk-and-reward relationship and always make these decisions wearing your perpetual time horizon glasses.





Source: Hirtle Callaghan.

Expected returns are internally generated long-term projections, based on Hirtle Callaghan proprietary research and models, which are hypothetical in nature and used for illustrative purposes only. These do not reflect actual investment results, are not intended to represent, and should not be construed to represent, predictions of future rates of return. Expected return estimates are subject to uncertainty and error. The expected returns shown do not reflect actual trading, liquidity constraints, OCIO fees, expenses, taxes and other factors that could impact an investor's realized future return. 75% stock/25% bond assumes an 18.75% allocation to private equity. This information is not intended as a recommendation to invest in any particular asset class or strategy. Hirtle Callaghan's ability to achieve the expected returns shown herein is subject to risk factors over which it has limited or no control.

What is the Role of Private Assets in Small Endowments?

The smallest endowments tend to have far less exposure to private investments, believing that they can't take on too much illiquidity risk. This is a misconception. Having lower endowment dependency and lower spending rates gives small endowments more flexibility to invest in private assets, including private equity and private credit. Over the past 15 years, global private equity has more than doubled the return of global public equity; the Burgiss Index has returned 14.2% relative to 7.0% for the MSCI All County World Index. Yet endowments under $100 million have 7% of their assets in private investments compared to 18% for endowments over $100 million. This discrepancy puts smaller endowments at a serious and unnecessary disadvantage. While their larger peers are taking advantage of their long time horizon, smaller endowments focus instead on their size as a deterrent. We encourage all of our endowment clients, regardless of size, to undertake a thorough liquidity study to determine how much they should allocate to private markets over time.

Key questions include:

- **How many days cash on hand does the organization have?**
- **Do operations generate a cash surplus or run at a loss?**
- **Does the organization have a line of credit? If not, what does its debt capacity look like?**
- **What are planned future capital expenditures?**
- **How much of the operating revenue is contributed by the endowment?**
- **Is there an operating reserve to draw on during periods of stress?**

Many organizations have significant reserves or operating surpluses that can provide an additional cushion if needed, enabling them to take on more illiquidity than they might think.

Conclusion

We are not recommending smaller endowments can or should take the same level of risk as the mega endowments, but many can and should take more risk than they currently do. To under-optimize your endowment because it is small is a self-fulfilling prophecy. At Hirtle Callaghan our "smaller" endowments consistently outperform similar-sized peers because our planning process includes a comprehensive review of your organization's ability to take risk. Those organizations that use the endowment's long time horizon to their advantage are able to grow their endowments more successfully and ultimately build a stronger financial model. Every organization needs more resources—why not choose the most optimal endowment strategy so that it will provide the most possible resources over time?

John W. Griffith

JGriffith@HirtleCallaghan.com

John is a Director and Endowment Specialist with Hirtle Callaghan. He has over 28 years of higher education experience. From 2003 until 2014, he was the Chief Financial Officer and Treasurer of Bryn Mawr College. As the Treasurer at Bryn Mawr, he oversaw an $850 million endowment, managed cash, issued debt and was responsible for budgeting and strategy planning. At Bryn Mawr, he assisted in modernizing and diversifying the endowment. During the latest recession, Bryn Mawr was one of only a few colleges whose debt rating was upgraded. Prior to Bryn Mawr, John spent 15 years in various financial roles at the University of New Hampshire. He started his career at Coopers & Lybrand.

John earned a Masters in Finance from Bentley University and a B.A. in Business Administration from the University of New Hampshire.

Anne D. Ford

AFord@HirtleCallaghan.com

Anne is the Director of Communications, responsible for nonprofit thought leadership and education. She brings 25 years of experience in investment management, including at investment advisor Gatemore Capital Management, where she was a member of the Investment Committee, and Seneca Capital Management, where she co-led the client service team. Anne started her career at Goldman Sachs Asset Management.

Anne graduated magna cum laude from Duke University with a B.A. in Political Science and received her master's degree from Columbia's School of International and Public Affairs. As a board member at several nonprofits, Anne brings firsthand knowledge on topics including board governance and nonprofit best practices. She serves as Chair of the Board of the Agnes Irwin School, an independent school for girls. She is also on the Board of the Preservation Society of Newport County, a nonprofit organization that manages and preserves historic mansions in Newport, RI.

HIRTLE CALLAGHAN & CO
Chief Investment Officers

Since 1988, Hirtle Callaghan has been proudly serving families and nonprofits as their Chief Investment Officer. We design comprehensive investment programs that are diversified across a broad range of asset classes, including public and private market strategies. With approximately $17 billion under management, we use our deep networks and purchasing power to facilitate access to world-class specialist managers and keep down costs. We always place our clients first, avoiding conflicts so every decision is in your best interest.

DISCLOSURE STATEMENT AND IMPORTANT INFORMATION

Hirtle, Callaghan & Co. ("Hirtle Callaghan") is a Delaware Limited Liability Company and is registered as an investment adviser with the U.S. Securities and Exchange Commission. Registration as an investment adviser does not imply any level of skill or training. Information in this document is obtained from sources which we believe reliable, but we do not warrant or guarantee the timeliness or accuracy of this information. This information is current as of the date of this presentation and is subject to change at any time, based on market and other conditions. Hirtle Callaghan shall not be liable for any errors or inaccuracies, regardless of cause.

The information presented in this document is general in nature and is not designed to address your investment objectives, financial situation or particular needs.