chief investment officer

Reprinted with express permission of CIO

How Smaller Endowments, Shut Out of Razzle-Dazzle Investments, Make Do

February 6, 2020 | ai-cio.com

They usually aren't wealthy enough to land high-powered private equity or hedge fund investments. So they turn elsewhere.

FOR MORE THAN THREE DECADES, some of the most enviable university endowments in the US have been rewarded with the highest returns by replicating the famed Yale Model. They benefited from a mix of alternative assets that had high thresholds for entry. These big funds possessed the heft to open those doors.

But for smaller endowments under $1 billion, which usually lack the entrée to private equity or venture capital, their investment professionals must scramble. Their goal: Find other investment vehicles that can potentially deliver stellar returns.

"Everyone tries to copy and emulate the mega endowments," said Jeffrey Mindlin, chief investment officer at ASU Enterprise Partners, the finance arm of Arizona State University's endowment. "They have certain competitive advantages that we may not have, so replicating what they do might not be what works for us."

Smaller endowments typically lack sufficient capital to access top-performing managers, as well as fewer resources to ferret out little-known genius investment managers. That means that less-affluent endowments have had a tough time keeping pace with richer ones, let alone the market.

In fiscal year 2019, every asset cohort under $1 billion failed to top the over $1 billion crowd, according to a study by the National Association of College and University Business Officers (NACUBO) and the Teachers Insurance and Annuity Association. Endowments in the $500 million to $1 billion range posted returns of just 5.1%, lagging the 5.3% total institution average and the 5.9% one-year return from the over $1 billion group, the report found.[1]

The same trend is true for the 10-year average, which is the number managers reference most often for future planning and spending. The $500 million to $1 billion players generated an average 8.5% return, while the over $1 billion funds gained 9%, according to NACUBO-TIAA.

Worth mentioning is the under $25 million cohort, which had the second-highest one-year return with a 5.8% showing last year, the report found. The smallest endowments benefited from the greatest exposure to public equity coming out of a long bull run. But according to NACUBO-TIAA, this also meant they had the lowest 10-year return out of all the funds with just a 7.7% gain, lower than the 8.4% total institution average.

Off-the-Run Strategies

Some experts recommend that universities get aggressive and hire outside consultants who have expertise in niche investing strategies that larger universities might overlook.

"Smaller institutions can consider off-the-run strategies that would not be practical for larger investors," said Patrick Adelsbach, head of credit strategies at advisory firm Aksia.

One strategy Adelsbach suggested for smaller universities is to look into middle market lending, which can broadly cover loans to companies with $3 million EBITDA or even $300 million. Or, they can also include loans against $2 million real estate developments or even $200 million developments.

"Smaller loans are generally riskier, but often offer higher target returns and can be made in less competitive areas of the market," Adelsbach said.

That's one big competitive advantage for Arizona State University, which made the jump early on to outsourced CIO (OCIO) managers to rewrite their strategic asset allocations. After partnering with BlackRock in 2017, ASU CIO Mindlin said the partnership had a "material impact" on its endowment, which gained 10.2% in the last fiscal year to $922 million.

That easily outpaced the performance of many endowments in the over $1 billion category, including Yale with 5.7% and Harvard with 6.5%.

Mindlin recommended that smaller endowments increase their

MKTGH0220U-1090407

All amounts shown are in USD.

fixed income allocations over alternatives, bucking the trend in larger investment portfolios. Bonds had a pretty good 2019 due to dropping interest rates, and ASU rode that trend by increasing its long-term fixed-income holdings to 20% from 10%. "That helped our returns," Mindlin said.

Another plus for ASU: its direct real estate investments, opportunities it says are not typical for its asset size. The university, which has five campuses throughout the Phoenix metropolitan area, has benefited from a burgeoning tech sector in Tempe.

In search of cheaper rents and lower costs of living, tech companies from neighboring California have set up satellite offices in the area.

Recession Fears

Then there is the question of how to handle a market downturn. In the NACUBO study, which was released last week, experts advised managers against using stock returns over the past 10 years as a benchmark in their planning, as it is reflective of the long bull market since the recession.

In fact, managers were warned that "it's going to be harder and harder to continue to get those types of returns," Dimitri Stathopoulos, head of US Institutional at Nuveen, a TIAA company, said during a media call.

"When the music stops, nobody knows," ASU CIO Mindlin said.

As concerns mount over possibly softening global economic growth, as well as declines in state support and rising pressure to curb tuition hikes, some experts recommend more endowments like ASU start retreating into fixed income to reduce overall portfolio risk.

"It's a very defensible position for many universities given the institution's financial health, dependence on the endowment to fund the annual operating budget, and sensitivity to declining enrollment or other revenue sources," Margaret Chen, global head of endowment and foundation practice at Cambridge Associates, wrote in an email.

But smaller endowments have at least one advantage in the next recession: Universities don't depend on the endowments to see them through, relying instead on enrollment and tuition to boost their operations. That's unlike places like Princeton and Harvard, which rely on their oversized funds to deliver around half of their annual budgets.

"They value that money, but it provides a very small percentage of their operating budgets," said Sandy Baum, senior fellow at the Urban Institute. "So, if they have a low return on their endowments, it has less impact on their budgets because most of their budget comes from tuition revenues."

Other Strategies

Another wise strategy for the smaller endowments is to invest in out-of-favor areas, such as health care. Many money managers are betting against health stocks amid the current election cycle.

Investors are concerned about increasing political pressure to curb drug prices, as well as other changes proposed from the 2020 Democratic candidates, like single-payer systems such as Medicare for All proposals.

Other strategies include betting against the energy sector, which has been beset with problems thanks to a deluge of crude oil in the market. In addition, endowments must contend with increasing pressure on universities from climate activists to divest of energy stocks.

Overall, the smaller endowments may have fewer chips to play, but if they nimbly play them, they can come out in pretty good shape.

[1] *https://www.nacubo.org/Press-Releases/2020/US-Educational-Endowments-Report-5-3-Percent-Average-Return-in-FY19*

All amounts shown are in USD.