

CHAPTER 10

SYNOPSIS

'The first act's doubtful, but we say, it is the last commends the play'

Robert Herrick (1591-1674)

Endowments and foundations are a unique type of long-term fund and they are unique in themselves: each fund has its own ethos, objectives, risk constraints and governing body of people who legally own, and who direct the management of, the underlying assets. Endowments and foundations generally have the longest term vision of any known funds but must still walk a tightrope of responsibility between the demands of the present and a duty to the future with little or no 'lender of last resort'.

Investment strategy for endowment funds is an holistic process, which means it is a process of forming a whole which is more than the sum of its component parts. Modern Portfolio Theory may have taken the theory of strategy beyond simply finding the best combination of money-making ideas. But strategy for endowments is even more than simply finding the diversified mix which hopefully provides the theoretical optimum portfolio return for every point on the axis of risk.

Ultimately endowments are subject to Micawber's Rule which equates investment return and other income with spending rates and endowment growth. Investment strategy must therefore be an integral and iterative part of a strategy which takes in to account other income, current and future spending policy and intended endowment and spending growth. The need to reinvest in the endowment simply to stay in line with inflation, which is called maintaining intergenerational equity, can be seriously under-estimated. At a time of low prospective nominal returns it is easy to retain legacy high nominal spending rates and to under-estimated the capital sum which is needed to sustain the activities of the endowment.

Understanding strategy must begin with understanding both the fundamental principles of investment and one of the commonest but least understood words in the language of investment: return. Spendable return may usefully be defined as the economist Sir John Hicks defined the word income: 'the wealth which can be consumed in a year which leaves unchanged the quantum of wealth left to generate the same income in the following year.'

The amount which is available to be consumed during the year is equivalent to total return less that which should be reinvested to maintain intergenerational equity. The quantum of wealth which is left at the end of that year to generate the same return in the following year is intergenerational equity, that is the capital which can sustain the same level of return in real (inflation adjusted) terms.

Inflation creates a money illusion which can lead to over-spending of current return to the detriment of the future because of insufficient reinvestment for wealth accumulation through compounding reinvested return. Disinflation can also create an illusion of spendable value when valuations adjust and provide one-off returns which can not be consumed if Hicksian 'well-offness' is to be sustained.

Consideration of Albert Einstein's eighth wonder of the world, the power of compound interest, exposes both the dilemma between spending now or growing for the future and the focus on relative return rather than absolute return. The use of time weighted return, which is a device for measuring funds with different cash flows comparably but not a measure of wealth accumulation, may sometimes obscure this underlying fundamental objective.

Financial return is created through entrepreneurial activity and financial intermediation. The central bank sets the price at which money is lent to the government and this establishes the risk-free rate of interest from which other rates are derived. Time is money and the future is uncertain creating a premium for risk which is amplified, in the case of non-government assets, by the economic cycle.

Guesstimating the future effectively requires analysis of the sources and drivers of return and of the validity of past relationships; it is not simply about extrapolating past returns. Planning involves recognizing future uncertainty through scenario analysis rather than single point estimates. It is more than the weighted average of most likely outcomes. As Keynes wrote : 'The assumption of arithmetically equal probabilities based on a state of ignorance leads to absurdities'.

Return can not be divorced from risk. The Chinese character meaning risk is a combination of the character for danger and that for opportunity and risk is something to be managed not just minimised. There is a long history in the development of the mathematics of risk which culminated in twentieth century modern portfolio theory (MPT). MPT first formally quantified financial risk as variance of return from the mean or average return. In other words risk was volatility.

One of the main developments of modern portfolio theory is that security returns have three elements: an underlying element of market return; an element which is leveraged to the market (beta) and an element which is independent of the market, called alpha. Alpha, which can be positive or negative, defines the source of value added to (or detracted from) a benchmark by active management of portfolios.

Another feature of modern portfolio theory is the shift in thinking towards the non-correlation of asset class returns as a measure of diversification, not just spreading risk over a large number of investments. From this developed the analysis of common factors between asset classes and securities and the analysis of portfolios by themes and by styles.

While modern portfolio theory has expanded the thinking on risk, simply equating risk to volatility is not sufficient when it comes to the mission of endowments. We define endowment fund risk as 'a measure of the likelihood and the extent to which an endowment's resources fail to meet its financial objectives during its expected life'. This definition follows the Sortino approach that risk for an endowment is failure to meet a minimum acceptable return. And the definition implicitly assumes that endowment fund risk takes in to account factors other than simply the volatility of return.

Risk is benchmarked to the liability demands on a fund over both operational and intergenerational time horizons. This implies that risk is particular to a given fund and not general, that the same conditions of risk can have different implications for different funds depending on a fund's objectives and liabilities. And this definition takes in to account both the timing and the duration of the impact of risk.

Spending Rules dictate the percentage of an endowment which can be consumed today at the expense of tomorrow. Intergenerational equity is maintaining sufficient value in the endowment to sustain grant-making in real terms for future generations. There is a symbiotic relationship between investment return, other income, current spending and growth of the endowment and therefore of the ability to spend in future. Inflation tends to distort spending ability by creating illusory income and capital gain. The illusory part of the income, in the Hicksian sense of the word, should be reinvested to maintain an endowment's real value and thereby to maintain real spending power.

Change in consumer prices can also cause illusory spending power through valuation change. A perpetual bond yield which halves through a halving of inflation doubles the price of the bond for no increase in income generation. It is an illusion to presume that the 100% rate of capital return on such a bond is now available for current expenditure. Rather, some of the 100% total return from that bond still needs to be reinvested to maintain the sustainable, consumable real income from the bond.

A spending rule which is purely a percentage of an endowment's net asset value provides some discipline but is not a complete answer. A better approach is to relate a percentage of the endowment value to the minimum acceptable return escalated by a price deflator component to account for the change in value of money. An upper limit spending rate also provides protection for intergenerational equity. In effect this approach generates a reserve in good times which can be drawn on in poor return times to maintain grant-making ability.

Until the second half of the twentieth century, few asset classes were available for investment by endowment funds. Modern portfolio theory and other financial

developments changed the way in which conventional assets were viewed. Modern portfolio theory also helped to expand the categories of asset and the financial instruments available as well as changed the approach to portfolio management.

Assets can be classified by use and by characteristics. The classification by use distinguishes between operational and intergenerational assets. The former are short-duration investments to cover, with a high degree of certainty, both the daily operating needs of an endowment over the budgeted period and the tactical and risk management needs of an endowment's portfolio managers. Such assets provide managers with a way, when necessary, to de-leverage portfolio risk caused by the more volatile intergenerational asset base – the long term endowment.

Intergenerational assets meet the longer term need to preserve or enhance intergenerational equity. They are long duration, often illiquid, higher return assets mostly with equity-like and long-term inflation-protection characteristics.

The asset classes within the operational and intergenerational classifications can behave like chameleons: some fixed income bonds can behave like equities while others will behave like cash or real estate depending on the financial background. Some equities behave more like commodities than other equities or even like bonds. And the behavior of all will vary as scenarios change. It is therefore the characteristics of these asset classes appropriate to different potential scenarios which will determine their relative portfolio weight in the total portfolio at any particular point in time.

One other ingredient to endowment strategy is the ethos of the endowment and its social policy towards acceptable investments. Some endowments have strong internal policies with rigid screens to exclude what they regard as anti-social investments. External pressures may influence 'socially responsible' parameters to investment as well, even if this is not outlined in an endowment's original constitution. And since the law today is society's resolution of the social issues of yesterday, some issues of today's governance best practice may influence the laws of tomorrow.

Today's laws are clear about the fiduciary responsibilities of trustees in balancing risk and return without jeopardising the interests of beneficiaries. While a study by the United Nations's Environment Programme Finance Initiative concluded that there was a threat to share price performance if ethical questions were ignored, it was also agreed that while corporate leaders have to think beyond just making profits, towards how they affect society, it is not their job to save the planet. And a session of the World Economic Forum concluded that good corporate governance and corporate citizenship should simply make good business sense.

Investment strategy involves assessing resources, quantifying objectives and marrying those two with a flexible plan which manages the risk that objectives might not be met. Quantifying objectives involves both a relatively precise budget covering the endowment's operating time horizon, usually a period of one to five years, and a more general long term, intergenerational objective which is measured in real terms.

The budget will set the level of minimum acceptable annual return required to cover day-to-day operations, including grant-making and administration, and from this will be derived the required level of operational assets. A second element of operational assets arises from investment management transfers and occasional tactical reduction of portfolio risk out of intergenerational assets at appropriate points of the financial cycle.

The allocation to different asset classes within intergenerational assets, within the long-term endowment, will be driven by the analysis of valuation criteria and of economic and financial scenarios. The objective with intergenerational asset classes is to 'avoid losers', to diversify amongst potential winners and to follow a discipline of rebalancing based on relationships, not on returns or fixed weights.

This approach to rebalancing is a contrarian one but not on the grounds that returns themselves are necessarily mean reverting. It is based on the evidence that relationships tend to regress to a mean for given scenarios. Relative valuations can become stretched to beyond reasonable limits for any given scenario. 'Avoiding the losers' involves reducing portfolio weight from such asset classes in to others where relationships are under-valued, or at the least normal, for the prospective most likely scenarios.

Implementing strategy for an endowment fund involves establishing principles and philosophy and structure and process. Structure and process set the parameters and procedures through which the endowment's mission and objectives are implemented by asset strategy. Structure and process are defined in the Investment Policy Statement (IPS).

Key to implementation is people, people involved on the board of trustees, on the investment committee, in the staffing of endowments and in service provision such as investment management, legal counsel and other consultancy. The key is the right skill and experience, balance and chemistry of people on committees, in the staff and in service providers especially asset managers.

Implementation involves deciding, monitoring and changing allocation between and within operational and intergenerational assets to balance current and future spending needs and to reflect external scenarios. It involves determining the investment management model appropriate to the size and sophistication of the endowment. It includes assessing styles of asset management and parameters of risk, selecting advisors and custodial relationships. It also requires identification of, and negotiation, on costs, especially the remuneration of asset managers. It includes monitoring the achievement of objectives and measuring results both quantitatively and qualitatively .

Implementation needs careful consideration of the benchmarks which are used for guiding strategy and for measuring investment management and other achievement. Benchmarks inevitably drive investment behavior so both the first and the second-order effects of benchmarking must be assessed. But performance measurement is about more than simply investment management results. It includes accountability for the outcomes

in the broadest sense and at all levels: of the governing body itself, the investment committee and the service providers. It is ultimately about how well the endowment or foundation meets, or if possible exceeds, its mission.