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CIO Roundtable:
Is the Endowment Model a Crowded Trade?

Forum Spotlights

From left: Jeff Pippin, Jennifer Paquette and Mark Anson

Stuck in the past or ever-evolving? The endowment model gets a hard look eight years into the current market cycle.

With core tenets of the endowment model seemingly under stress for the last several years, some investors have questioned the long-term viability of the model. At issue: Are too many investors piling into the same ideas and thus squeezing out opportunities for better returns? At this Commonfund Forum 2017 general session, three CIOs tackled questions designed to surface concerns about the model and provide insight based on their long experience.

The roundtable was moderated by Mark J. P. Anson, PhD, Chief Investment Officer of Commonfund. The participants were Jeff Pippin, Senior Vice President and Chief Investment Officer of Pepperdine University, and Jennifer Paquette, former Chief Investment Officer of the Colorado Public Employees Retirement Association.

Mark Anson: We're going to talk about the endowment model and whether it's a "crowded trade", a popular term that simply means too many people are piling into the same investment ideas. The question is, by having so many people pile in, does that squeeze out the excess returns that might be associated with that investment idea? Normally, that applies to talking about active managers or hedge funds, but we're going to take that idea of a crowded trade and broaden it to the full-blown portfolio concept that's called the endowment model.

Jennifer, I'll start with you, we'll go on to Jeff and then I'll throw my chips on the table. The "endowment model" is a term that's been part of the popular vernacular for some time. People use it, but very rarely do they actually stop to define what it means. So, to you, what does the endowment model really mean?

Jennifer Paquette: I look at it fairly simply in terms of it being a model that has more alternative investments in the portfolio, and being fairly innovative in terms of looking at types of new and complex strategies, from hedge funds to other strategies that fall into private markets or alternatives.

Jeff Pippin: It's kind of hard to define the endowment model because different institutions apply it differently. In general, I look at it as broadly equity-based with a significant allocation to alternatives, and a willingness to take advantage of an illiquidity premium. Over the years, more and more institutions are going into alternatives and private investments to diversify away from public markets and seek the potential for added return from illiquidity.

> *Is diversification still the last 'free lunch'…or maybe just a free cup of coffee?*
>
> *– Mark Anson*

Anson: From our perspective, we view the endowment model as having three basic tenets. One is an equity bias, and the reason for that is tapping into the long-term premium associated with global economic growth. As part of your intergenerational equity, or trying to grow the portfolio over generations, tying into that long-term growth premium is very important, and the best way to try to do that is through the equity markets, both public and private. The second is diversification, and I'll come back to it in a moment because I do want to tee that up a bit more. But, basically, diversifying not only away from stocks and bonds, but also into alternative investments. And then, last, it's trying to capture that liquidity premium. One of the things we do at Commonfund is to measure the liquidity premium. We measure it back over long periods of time; on average it's about 320 basis points over and above the public stock markets. If you're going to lock up your capital in a private investment, like private equity, you should earn some premium over the public markets. Otherwise, you should just buy the S&P 500. And that long-term premium that we've measured is about 3.2 percent, although right now our model indicates it's closer to 6 percent.

But there's always a catch: Just because the liquidity premium exists, doesn't necessarily mean you get to earn it. You have to go out and find good managers who will earn it for you.

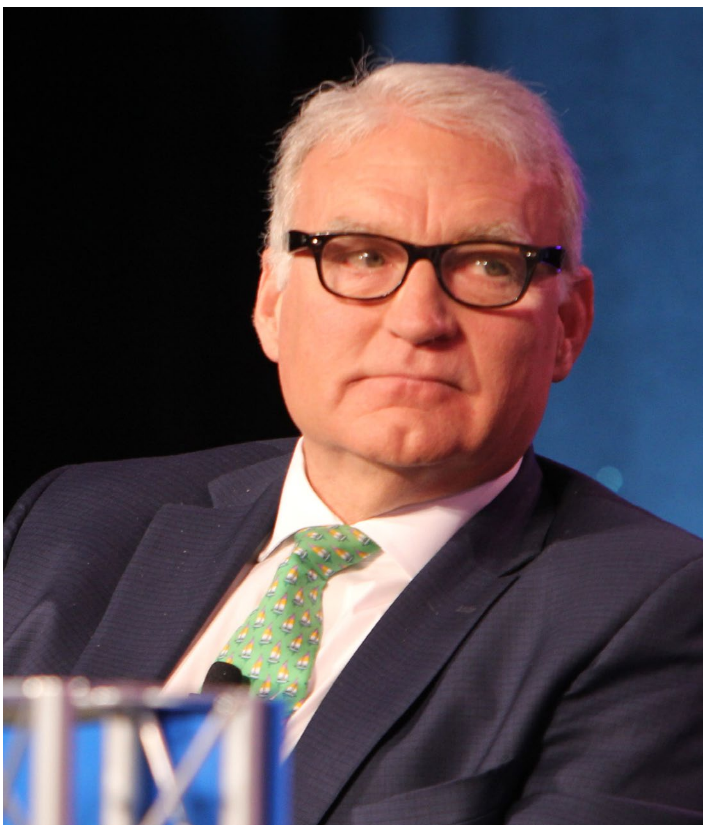
Let's come back to diversification, something that has been referred to as "the last free lunch." If the endowment model really is a crowded trade, do we still get that free lunch? Or is diversification today maybe just a free breakfast or free cup of coffee?

Jennifer?

Paquette: I don't know what there is without diversification. Whether we get a coffee out of it or a breakfast or a lunch, I think it's really challenging to try and come up with other methods of managing an institutional portfolio. We've talked some about correlations increasing across asset classes. That's something to take note of and think through in regard to your expectations for how various asset classes are going to behave in different circumstances going forward. But, I don't know what else there is without using different asset classes and strategies to build a portfolio to achieve your long-term funding goals.

Anson: So, hard choices. Jeff, how about you?

Pippin: Diversification is something that we probably all struggle with. How can we actually achieve diversification? If you look back to the crisis in 2008 and '09, a lot of us thought we were pretty diversified. But, when we looked at our portfolios and how they reacted to the crisis, it didn't look like we were diversified after all. So, it was a lesson not to completely trust the correlations that you use in building your portfolio. You've got to look deeper to see how those things are going to react to each other in a crisis. Some people call it stress beta. You can't get the level of diversification from stocks and bonds anymore that you used to—70/30 doesn't work for our needs right now. You can't get 5 percent plus inflation out of 70/30. Plus, we're coming into a situation where you might see bonds being more closely correlated with stocks as interest rates rise.



Jeff Pippin

We focus a lot on diversifying away from equity risk and not wanting to be in the same position that we were in after the crisis. One of the things that we have done is take a 10 percent allocation from our equity portfolios and put it in what we call a diversifying portfolio. This is a group of hedge funds that we've modeled extensively and that we believe will give us an expected return with low or no correlation with equities. The portfolio modeled out at around 8 percent historical returns with very low correlation among the managers and the strategies. The benchmark is Treasuries plus 4. We implemented it on June 1 of last year—just in time for Brexit—but it did okay during Brexit and continues to perform in-line with its benchmark.

Anson: I want to ask another question: Is there a role for bonds in a diversified portfolio? You talked about how low-yielding they are.

Pippin: This is the next thing that we're turning our attention to because, like most endowments, we do have a bond portfolio. We don't have a credit allocation. We do credit opportunistically, mostly in hedge funds and some distressed. Our allocation to fixed income is to intermediate-term Treasuries, and we have it there for two reasons. One, we want to have a portion of our portfolio that is liquid and is not going to tank with the market. We look at it as a source of dry powder. You're giving up return to have dry powder—optionality, if you will—if you find you have better opportunities in which to invest. And, two, we want to have two years of payout on hand, so we have a 10 percent intermediate U.S. Treasury portfolio.

Paquette: I think there's a place for bonds in the portfolio. In the pension world, there tends to be higher allocations to fixed income than in in the endowment space. But, whether you're in foundations and endowments or public funds, bonds have a role in terms of providing liquidity when you need it or want it for other investments. At Colorado PERA we call it the anchor to windward. When I look at how institutions change their allocations, I found it interesting that Pepperdine chose to take assets from equities to put into that hedge fund portfolio. What we sometimes see is people taking allocations from fixed income and then putting them in other equity-like investments, so they're really raising the overall equity risk of their portfolio. I think it's really important not only to consider what the right amount of fixed income is, but about how we manage that asset class—that we're not just managing it for a 2008-type downturn. We're not managing it just for a low rate or high rate environment, but we're looking for it to be a long-term diversifier even though at times it can be certainly highly correlated with equities.

> *"We've evolved into being less passive and more active [as] we view ourselves as investors rather than just capital allocators.*
>
> *– Jeff Pippin*

Anson: An observation I would make is that the bond market has sort of flipped. If you go back to 2008 and you look at what's now called the Bloomberg Barclays Aggregate Bond Index, which is an investment-grade index, it yielded about 6 percent and the duration, a measure of bond beta, was about 2.7 or 2.8. That has flipped around now. The duration is now about 6, and the yield is only around 3 percent. Now, you're taking on more risk for less yield. So, as we think about bonds going forward, it does seem like interest rates are likely to go up, and that's going to be bad for the bond market. Bonds are still a good shock absorber—the optionality that Jeff was referring to. The kicker is that over the last 30 years, during this tremendous bond market rally, you got to own these insurance policies called bonds and you got paid to own them because as interest rates went down, bond prices went up. Going forward, they'll still be good insurance policies, but you'll have to pay for that insurance.

I want to come back to defining the endowment model again. Over time, the model has evolved through three stages. Stage one was when endowments and foundations first began diversifying out of bonds into public equities. Stage two was diversification, and trying to expand beyond bonds and public equities into things like hedge funds. Stage three entailed a more focused approach to try and capture the liquidity premium through private capital. Now we're into stage four. What is stage four?

Pippin: My team and I spend a lot of time discussing that question. For us, it comes down to how to remain equity investors. We're going to have to participate in growth. Over the long term, we're putting our bet on growth. And we want to be owners, not creditors. We've evolved as an institution into being less passive and more active, and that has to do with viewing ourselves more as investors rather than just capital allocators. We're spending a lot more time with our managers. We're trying to identify our best managers, and then we're asking to co-invest with them as opportunities arise.

We've increased our allocation to real assets because we believe that the threat of inflation, given where we are in terms of the monetary cycle and where the economy is going, is greater than deflation.

We've had a hedge fund portfolio for a number of years, spend a lot of time modeling it, doing attribution analysis and gaining confidence in our managers. At one point a couple of years ago we asked ourselves, what do we really want from hedge funds? Do we really want to pay 2 and 20 to get a return that's a little less than the public equity market with slightly less volatility? The answer is no. What we really need is alpha. So, we went back to that 70/30 equation and asked, "What are you going to get from a 70/30? How are we going to get to 5 percent real?" Using some of these forecasts, it didn't look so great. You've got to get it from alpha. So, we took our hedge fund bucket and did away with it. We had a 15 percent hedge fund bucket. We just took that out of our asset allocation and put it over in the equity allocation. And so, we're treating our hedge funds as an alpha source, an alpha engine.

Anson: At Commonfund, we're working on the same idea in our hedge fund portfolio, which is to ensure we're not paying 2 and 20 for market exposure, which we define as exposure to the stock, bond and credit markets. So, we are stripping out all the elements of market risk because we know we can get them more cheaply. What's left over is the alpha stream that Jeff was talking about. That's what we concentrate on bringing into the portfolio, and that's why we've redefined our benchmark for the hedge fund portfolio to be Treasury bills plus 4 percent ... because what we want to bring into the portfolio is not the systematic risk of the equity, bond or credit markets, but a differentiated return stream that we can't replicate cheaply otherwise. Under the equity framework we've gone through and renegotiated all of our fee structures. We now know that every basis point of fees that we can reduce is another basis point in the client portfolios. That's part of the next evolution of the endowment model. Yes, we're all expanding into alternative asset classes, but let's be cost effective as well as constructing efficient portfolios on a risk/return basis.

On the diversification side, we're using more factor analysis to build better diversification into our portfolios. Instead of doing the top-down dollar allocation diversification of the past, we now diversify from the bottom-up by decomposing every manager we look at into their risk factors, and then combine those risk factors in the most diversified portfolio possible. Lastly, on the liquidity premium, as we talked about before, we can now measure precisely what that the liquidity premium is. That gives us a better sense of how we want to allocate private capital into portfolios. So, it's less about changing something dramatically and more about refining the model.

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>
> *– Jennifer Paquette*

That's what stage four is.

Pippin: If you look at a broad cross-section of private equity managers, you're probably not going to get that liquidity premium. You're going to get it by selecting the managers that have the skill and ability to give you that 300 to 400 basis points. It's not a given—you need to pick the right managers.

Anson: Love this topic ... it raises the question of whether private equity is a crowded trade. If you go back to 1980, there were only about 20 private equity funds or firms in the world. There are now over 7,000. That's a lot of private equity firms, all competing to put private capital to work. Jennifer, how do you play private equity?

Paquette: I think you've got to think long term and ask, "do we want to be in private equity? Probably, yes." But I do think it's a crowded trade, and you need to pick your spots very carefully. We're looking at smaller managers investing in smaller companies. We're trying to identify managers that we think can deliver alpha. We're being more conservative. We're doing more co-invests rather than pooled investing. We have pockets of liquidity all over the portfolio because we believe that over the next four or five years there will be good opportunities to put money to work.

Pippin: We also think it's crowded. But the way we've approached investing in private equity is to have fairly similar allocations every year. We're not sure we have the ability to forecast what is going to be a good vintage year and what will not. And, really, it's going back to manager selection. First, we're picking the manager, and then we're relying on the manager to deploy the capital when they see the opportunity, knowing that they usually have an investment period of about four years or so.

Anson: We agree, private equity is a crowded trade. That said, the industry is very different from 1980. Mostly, what private equity firms were doing was to bid on conglomerates, basically companies that had a mashup of different subsidiaries thrown together in a corporate mosaic. Those conglomerates were poorly understood and, consequently, typically undervalued. What did private equity managers do? They bought these conglomerates cheaply, added some leverage and then broke them apart and sold them off piecemeal. It worked like a charm until there were no more conglomerates left.

Now the game is adding value, and it's not just leverage. Any smart chief financial officer knows how to use his or her balance sheet nowadays. So, bringing leverage to the table is not really a value driver anymore. It's operational expertise that drives value creation. A private equity manager today has to understand the industry that the company is working in, the competitive landscape, the distribution, the products, the pricing of those products and how to be more efficient in the manufacturing process.

Back to Jennifer's point, typically it's the smaller to midsize private equity managers that do better.

Let me turn to another topic: King Kong versus Godzilla. Recently, I wrote an article titled, "Active Versus Passive: There Is No Debate." I started off talking about those cheesy old movies from Japan that pitted King Kong versus Godzilla. That's sort of what the active versus passive debate has become. It's King Kong versus Godzilla, active versus passive. Let's say King Kong is active and Godzilla is passive. Who wins? Does there have to be a winner? Can both coexist?

Paquette: In my experience, passive has a place, so it isn't either or. Being able to buy beta that's inexpensive to the equity or fixed income market can be attractive. There is a place for active management. We're not looking just for market returns, we want market returns and then some. Active managers go through alternating periods of underperformance and outperformance versus the market. Do you think that you can predict when that cycle is going to begin and end? I'm not sure I can. So, utilizing both is helpful. At Colorado PERA, we had different reasons for using passive in equities and fixed income. In equities, it was really related to cost and giving us that beta less expensively to add our overlay of active managers, internal and external. In fixed income, it was a little different. A fixed income index can give you such a broad array of securities that if you're running an active fixed income portfolio, you might own 200, 300, 400 securities. An index fund can have thousands of them. We found it interesting to have that kind of very well diversified exposure from a seasoned index portfolio, and it also related to the fact that we were running a lot of money internally. If we ever got into a position where we lost some of our talent, where would we go with our assets until we placed them with other managers? We wanted that index sleeve as kind of a holding place should we need it at times.

Jennifer Paquette

Pippin: Going back to the beginning of the bull market in bonds, if we knew then what we know now, we would have invested in 30-year Treasuries. But that's managing by looking in the rearview mirror. Today, the only way that we get to 5 percent plus inflation is by being active. We're going to be facing a totally different environment in the next five to 10 years, and what worked in the past is not going to work in the future. I would definitely be King Kong. I never liked Godzilla.

Anson: At Commonfund, we believe in active management. But, we also believe there's opportunity to add passive. Certainly, as we think about how we want to put on tactical overlays, a more cost-effective way to do this is passive.

To return to Jeff's point, investors are influenced by what they see in their rearview mirror. When you look backwards, yes, we have seen that active has underperformed. In fact, 2016 was the worst year for active management over the last 27. So, our view is deeply influenced by what we see in the rearview mirror. What's not so obvious is that going back to 1990, every year that the S&P 500 had a negative return active outperformed passive. Active managers have been a natural buffer in down market years, and that's a good thing to remember. We're into year 10 of economic expansion and sooner or later we will hit a speed bump, and when that bump hits it will be good to have active management in the portfolio.

Bear in mind, as well, we have had massive amounts of quantitative easing poured into the economy—and not only ours, but those of Europe, Britain and Japan. In July 2016, the 10-year Treasury got down to an amazingly low yield of 1.35 percent. What happened? Utility stocks became the new bonds. In 2016, when the S&P was up only 4 percent, utilities were up 32 percent. Remember, utilities have a beta of 0.6 to 0.65, so they should be earning less than the S&P 500. Yet they were earning eight times more. Why? Investors were trading out of bonds and into utilities—stocks with very low betas, very low growth rates, but high dividend yields. What's the problem for active management? Active managers don't buy utilities because they're the most boring, low growth stocks in the S&P 500 and the Russell 1000. So, the stocks that have done well recently are the ones that active managers tend not to trade in simply because they don't generate any growth. All these factors came into play and resulted in active not performing well recently. Keep in mind, however, that there are good reasons to adhere to active management. I can't think of a better one than what Jeff indicated: If you're going to get to CPI plus 5, passive most likely doesn't get you there.

15 Old Danbury Road
P.O. Box 812
Wilton, CT 06897-0812

Tel 888-TCF-Main
Tel 203-563-5000
www.commonfund.org

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