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The Ever-Evolving 80/20

A Commonfund Viewpoint

On average over the past decade, independent schools participating in the Commonfund Benchmarks Study® of Independent Schools have maintained an asset allocation that stays within a few percentage points of 80 percent equities and 20 percent fixed income (when fixed income and short-term securities/cash/other are combined). If that 80 percent represents the tip of the equity allocation iceberg, however, beneath the surface there have been substantive changes.

Of the three broad equity allocations, non-U.S. equities has been the steadiest. This allocation was at its height in the three-year period of fiscal years 2017, '18 and '19 when it averaged 21 percent. It was at its lowest at the beginning of the 10-year period in FY2011 and FY2012 when it stood at 16 percent and 15 percent, respectively. For the entire decade, the average allocation was 18.3 percent. Of note, while allocations to U.S. equities and alternative strategies varied widely across the three size cohorts, non-U.S. equities was consistently the most level.

U.S. EQUITY ALLOCATION GROWS

The allocation to U.S. equities has grown over the 10-year period, reaching its high point of 31 percent in this year's Study; its second-highest allocation, 29 percent, occurred just last year. The allocation began the period under study at its lowest allocation, 24 percent. This allocation tended to vary more widely across the size groupings, with schools having assets under $10 million consistently reporting the largest allocations—occasionally reaching twice that of schools with assets over $50 million. Across the full decade, the average U.S. equities allocation among all participants was 27.1 percent.

The allocation to alternative strategies can best be analyzed by dividing it into three time periods. During the first, fiscal years 2011 through 2014, the average allocation was 39 percent. During the second period, fiscal years 2015 through 2017, this allocation averaged 34.3 percent. During the most recent three-year period, fiscal 2018, '19 and '20, the allocation averaged 31.7 percent. Alternatives strategies showed by far the widest variability across the size cohorts. In this Study, the largest allocation, 37 percent, was found among schools with assets over $50 million; the smallest, 3 percent, was among schools with assets under $10 million; schools with assets between $10 and $50 million fell in between, at 12 percent. Across these three size groupings, the largest allocation to alternative strategies occurred in FY2012, at 46 percent, 28 percent and 8 percent (although schools with assets under $10 million reached a 10 percent allocation in FY2016 and FY2017).

BEHIND RECENT TRENDS

One trend illuminated by the data over this span of time is growth in public equity market allocations while less liquid alternative strategy allocations have eased. Why? There is no conclusive answer. In this year's Study, the largest institutions have maintained the biggest allocations to alternative strategies and that may be more easily discerned: They have larger internal staffs, larger investment committees (including more members with alternatives experience) and, potentially, greater access to managers with a record of delivering first-quartile returns.

Turning to the markets themselves, U.S. equities have been headline news because they have outperformed their historic norms over the years being considered in this analysis, the steep declines of 2007 and 2008 having dropped off 10-year calculations. At the beginning of the period, U.S. equities were fueled by a rebound from the depths of the Great Recession. While economic recovery was gradual and strung out over a few years, public equities outpaced the economy (the "Wall Street versus Main Street" scenario). Smaller endowments, in particular, tended to remain liquid and "conservatively" structured as the U.S. equity market gained momentum through this period.

The following highlights a few of the trends have characterized the U.S. equity market in recent years. In the environment that has prevailed during this period it has been difficult for many active managers to keep pace with passive indices.

- Large- and mega-cap stocks, especially in information technology, have driven domestic stocks to new heights, but also helped to concentrate the market: Witness the FY2020 performance of the cap-weighted S&P 500 Index over the equal-weighted index—up 7.4 percent for the former, down 3.3 percent for the latter. (This is not a one-year exception, as the equal-weighted index trails the cap-weighted index for three-, five- and 10-year periods.)

- Another concentrating factor has been growth style stocks outperforming their value style counterparts for years, leading to a market of haves and have-nots. For example, for FY2020 the broad market Russell 3000 Growth Index returned 21.9 percent while its value counterpart retuned -9.4 percent. This is not a new phenomenon, either, as the Russell 3000 Growth Index has returned 15.2 percent annually for the past five years while the R3000Value has returned 4.4 percent.

- Investors have also been willing to invest in lower quality stocks and driven these stocks to outperform higher quality issues in many instances. For example, the highest quality stocks (fifth quintile) in the S&P 1500 Index[1] returned 16.8 percent for the calendar year ended December 31, 2020; stocks in the second quintile (the next to lowest) weren't far behind at 12.8 percent. The same gap narrowed to less than 2 percentage points for the trailing five years. To cite another example, the 200 stocks with the highest return on equity in the Russell 1000, i.e., good quality stocks, returned 19.8 percent for the period ended December 31, 2020. The 200 stocks with the lowest ROE, which are low quality stocks, returned 29.4 percent. In two of four measures, low quality stocks outperformed higher quality stocks.[2]

LONG TERM VERSUS SHORT TERM

Recent outperformance by U.S. equities tends to obscure the fact that alternative strategies in many instances have kept pace or outperformed over the longer term. For the trailing 10-year period, for instance, the Burgiss IQ – VC and PE benchmark lags the S&P 500 by only 60 basis points and is ahead of it for the trailing three and five years.

There is now anecdotal evidence that some independent schools may be looking more closely at alternative strategies based on relative valuation. If valuations of alternatives like private equity and venture capital were once considered frothy, that same description now attaches to large swaths of the U.S. equity market. Another factor is schools deciding to increase allocations that have become relatively small as a share of their total endowment. One case in point may be schools with assets under $10 million, as only 3 percentage points of their 64 percent total equity allocation is in alternative strategies.

Finally, there is the issue of portfolio rebalancing, that is, how much of the larger allocation to U.S. equities is market action and how much is rebalancing to the policy allocation? Once again, there is no clear answer, but there are inferences. While CSIS has not inquired about portfolio rebalancing in the past five Studies, there are data from the first half of the decade. The pattern that emerged during this period is one in which schools in the two larger size cohorts rebalanced much more frequently than schools with assets under $10 million. On average, 77 percent of schools with assets between $10 and $50 million rebalanced each of those years followed by 68 percent of schools with assets over $50 million. By comparison, an average of 47 percent of schools with assets under $10 million rebalanced each year. If those rates remained relatively stable over the second half of the decade (granted, an assumption), schools in two size categories were actively maintaining a more balanced, but equity-oriented allocation. For instance, in FY2020 schools with assets over $50 million allocated 31 percent to U.S. equities and 30 percent to alternative strategies (plus 19 percent to non-U.S. equities). Schools with assets under $10 million, however, allocated 43 percent to U.S. equities and the aforementioned 3 percent to alternative strategies (plus 18 percent to non-U.S. equities). The split for schools with assets between $10 and $50 million was 39 percent and 12 percent (plus 18 percent non-U.S.). The question is whether many schools simply chose to let their winners run instead of rebalancing to the policy allocation.

CONCLUSION

The decade discussed may reveal trends, but trend is not history. The most far-reaching development over the past several decades has been the acceptance of investing for total return, which drove the historic shift from fixed income to equities. Within that landmark change came another profound shift—especially for institutions with perpetual time horizons—and that was allocating a portion of the equity portfolio to alternative strategies, not only for higher potential returns but also for greater portfolio diversification.

After a period of exceptional equity returns, some market pundits are calling for a reversion to the mean. But they have done that before without seeing their forecasts realized. The future is unknowable. More than ever, the tenets of the endowment model—including diversification with an equity bias and a long-term perspective—appear to be the foundation for forward-looking asset allocation policies.

1 The S&P 1500 comprises the S&P 500, the S&P 600 and the S&P 400 and, in total, represents 90 percent of the capitalization of the U.S. equity market.

2 Russell 1000 Composition and Characteristics as of December 31, 2019; the four measures of quality are return on equity, current ratio, debt/equity ratio and price/book ratio.

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