# Best Approaches for Foundation and Endowment Investing

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Many investors are looking to endowments and foundations to learn their secrets for success. Interviews with chief investment officers at 12 such institutions reveal, among other things, common manager-selection traits. But perhaps of utmost importance is the overall environment that allows these funds to thrive.

Many investors seem to believe that foundations and endowments have discovered some secret to investing. They envy the kind of results David Swensen has been able to achieve with the Yale University Endowment. But Yale's is not the only success story. So, for *Foundation and Endowment Investing: Philosophies and Strategies of Top Investors and Institutions*, we interviewed 12 other successful chief investment officers (CIOs) at foundations/endowments to learn their stories.[1]

The goal was to find a mix of institution sizes, from more than $20 billion in assets (University of Texas Investment Management Company) to roughly $500 million (Henry J. Kaiser Family Foundation). We wanted a mix between foundation and endowment, between public and private, and between people who had held their position for many years and those new to their role. We wanted to get a cross section of approaches, experiences, and so on. In particular, we wanted to look at the institution's mission statement, investment policy and implementation, asset allocation, benchmarking and performance evaluation, and governance.

[1]Lawrence E. Kochard and Cathleen M. Rittereiser, *Foundation and Endowment Investing: Philosophies and Strategies of Top Investors and Institutions* (New York: John Wiley & Sons, 2008).

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## Lessons for Investors

What we found in our interviews is that a majority of those we spoke to share a value orientation. Moreover, although all like to think of themselves as contrarian investors, obviously not all investors can actually be contrarian.

Some tend to be what I would call "old school" from the standpoint that they break up the world into unique buckets—U.S. equity, non-U.S. equity, fixed income, real assets (which is then broken down into real estate, energy, timber, etc.), private equity (buyout, venture, mezzanine, distressed), and so on. Some investors have these buckets they are looking to fill, and they have a target asset allocation with these buckets. But more and more people are becoming what I would call "thematic investors." They try to find a sector or geographical area with a supply–demand mismatch of capital, such as energy or natural resources in general.

Asset allocation has undergone an evolution toward more of a bottom-up approach, particularly in the allocation to alternative investments. Let me describe what I mean. In a top-down process, the investor conducts some type of asset/liability study (for defined-benefit pension plans or to meet the liquidity needs of endowments) using perhaps mean–variance analysis or Monte Carlo simulation to drive the asset allocation process.

In a bottom-up process, the investor looks for managers who are truly adding value as opposed to the value coming from beta or the asset class.

 

Managers who have some true edge and who seem to be able to generate value in the future typically have capacity constraints. The investor may not be able to invest with the manager at all or may be able to invest only a little. Most likely, in such cases, the investor will want to try to invest as much as possible with that manager. Thus, capacity affects the potential allocation.

Also affecting the asset allocation process is staffing. For the Georgetown University endowment, we have three investment people—far fewer than the investment staff at Yale. So, execution (the ability to conduct due diligence and research) is an issue. We just cannot cast a net quite as far as some of the large institutions, and that constraint influences our asset allocation. The result is that we probably have a little less in alternatives and a slightly more concentrated portfolio of managers than the large endowments.

Thus, this bottom-up process focuses first on finding the value-added managers, with the actual allocation being driven by the manager's capacity and the staff's ability to conduct due diligence and monitoring. This method is far different from a typical top-down assessment in which the investor says: My expected return from, for example, venture is $x$, the correlations are $y$, so the mean–variance optimizer indicates venture should have a 3 percent allocation, so I now need to fill up that bucket 3 percent.

## Manager Selection

The CIOs we interviewed for the book were generally looking for managers with the following characteristics.

**Personal Qualities.** From the investor's perspective, the manager should be someone you want to spend time with, someone you trust. Scott Malpass mentioned in the interviews that when you hire a manager, it is not as though it is a vendor relationship. It is more of a partnership. It is more like you are hiring an employee, an extended staff member. In a sense, you are holding the manager to a much higher standard than the vendor that supplies you IT services or phone services. What you are trying to get from the manager is a long-term relationship with someone you are comfortable with, someone you like spending time with, someone you can kick around ideas with.

**Edge.** Defining "edge" is difficult, but essentially, it is a competitive advantage. In this efficient market world, anomalies may exist, but many people are competing to find those anomalies. At some point, all the marketing presentations begin to sound the same. Fundamental managers tend to say: We are bottom-up stock pickers; we conduct great due diligence; we do great field research; we call the suppliers; blah, blah, blah. So, what is it that makes this manager different? Maybe the manager is processing information in a unique way, or maybe the manager has a narrow focus. One of the more narrowly focused managers I ever talked to was someone who invested in small-cap medical device companies. Thus, perhaps the manager has a very narrow focus and has been investing this way for years, so you have confidence that the manager knows these companies better than anyone else—that is, the manager has an edge in the processing of the information.

Quant managers also need to have an edge. Although you are never going to get into the kind of extreme detail that will reveal what factors they are betting on, you can try to determine what it is about their research process that gives them an edge over the other hundreds of quants out there.

In private equity, one of the things we look at is whether the manager can add value to the portfolio companies. When we can, we try to find a manager who has not raised too much money, who has established a successful track record making positive changes at the portfolio company level (whether through successfully growing a company or by cost reduction), and who has done so on a fairly consistent basis.

On the public equity side, one of the things we have done is hire what are now commonly referred to as "activist managers." Some activist managers are what I would call the "green mail" variety. That is, they take a stake. They rattle their sabers. They make a lot of noise. They write a lot of letters. When the stock price goes up, they sell. But what we are looking for are what I call "friendly" activists, those who take meaningful stakes in companies and really become partners with the managers of the companies by trying to guide them and improve the companies. Because of the limited number of managers and companies in this area, it is relatively easy for our small staff to talk to the companies and the other players involved to determine whether the manager has had a positive impact.

**Transparency.** By transparency, what we look for is not so much position-level transparency or risk-exposure-level transparency. We take it a step further and look for process transparency and investment-thinking transparency. We want to be able to talk to the portfolio managers and analysts and find out their thoughts; we do not want it to be an opaque process.

 

Because we want the relationship to be a partnership, part of the value of having the manager is what the manager can add to the entire portfolio, not just to his or her piece. If I trust the manager's opinion and the manager likes what is going on in Japan right now, even though the rest of the world does not feel the same way, we may use that information to increase our allocation to Japan. We want that type of transparency of the process.

**Capacity.** Just finding a "good" manager is not enough. Capacity, as I mentioned, can be a problem. You may want to invest with some managers that you simply cannot. So, capacity issues are a factor in manager selection.

**Performance.** Everyone we interviewed *said* they do not look at performance, but everyone I know *does* look at performance. Although all of our interviewees said they have hired a manager who has had bad performance, such hirings are infrequent. We all like to think we are contrarians, that we will invest in a manager who is down, but we do not frequently do that.

**Fees.** The fee structure of funds is getting, in many respects, more egregious. A number of our interviewees stressed the importance of an alignment of incentives between the manager and the investor.

The case has been made that a successful manager has every incentive to structure fees in a completely one-sided manner. Consider that if alpha is scarce and only certain managers have this scarce alpha, in theory, the manager should be able to extract all of that alpha in fees. So, the manager will increase fees to the point he or she has earned every last dollar of alpha. To some extent, that situation may be occurring now. A private equity fund, a premiere fund, in its recent fund offering changed the structure of the fund so that the net effect was a substantially higher fee, and only one institution dropped out. Fees clearly must be part of the manager selection process.

## Future Challenges

Ultimately, I think it is the overall environment at all these institutions that has led to their success. Consequently, one of the challenges facing these successful institutions will be to maintain this environment into the future.

One of the factors that has led to the success of many institutions has been the longevity of the CIO. David Swensen at Yale University, Scott Malpass at the University of Notre Dame, Alice Handy at the University of Virginia, Allan Bufferd at Massachusetts Institute of Technology, Laurie Hoagland at Stanford University, Jack Meyer at Harvard University—all have been or were in their positions for a long time. The overall environment allowed them to make contrarian decisions, which often take years to pay off. These institutions recognized the importance of keeping good people in place long enough to see whether their decisions led to good or bad results. But funds are subject to many random events over which the CIO has no control. And the CIO, often one of the most highly compensated people at a university, is very visible. Moreover, the CIO is also being held to increasingly short-term performance standards. The result is an increasing amount of turnover in the position. Longevity is also being threatened by the hedge fund compensation structure, which is attracting top talent from endowments and foundations. This lack of longevity may affect returns in the future.

## Identifying Edge

Every institution should identify its edge. Part of our edge at Georgetown is that we are small. We may not have a large staff, but because we are small, we can still get a $10 million allocation for a fund that is otherwise hard closed and have it be a meaningful allocation.

Being an academic institution also gives us an edge. Right or wrong, the perception is that we are smart money. But more importantly, we can draw on an alumni network. At Georgetown, we have a very international alumni base, and we are starting to make use of that knowledge. Furthermore, like many of my counterparts, I have been teaching for years, so I now have a number of students who are working in private equity funds and hedge funds. It is a tremendous network. I use them for information, and I have hired them as full-time staff as well as interns. I have 12 part-time interns, with 2 or 3 in the office at any given time. Many of them are international students. I have four interns from China who have helped us conduct due diligence in that country by calling on companies whose management does not speak English. So, we try to take advantage of what we have.

## Conclusion

At its heart, endowment and foundation management is very much a people business—the people we have internally, the partners we have as managers, and the alumni we are networking with to find ideas or conduct due diligence. This business is much more qualitative than quantitative. And our opportunity to talk to the smartest people in the world makes the job fun.

This article qualifies for 0.5 CE credits.

# Question and Answer Session

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**Question:** What do you think of the outsource business model for small- and medium-sized endowments?

**Kochard:** I'm a big fan of the outsourcing model, but the jury is still out because it is still in its infancy. Certainly, there are economies of scale and diseconomies of scale. Large endowments have outperformed the smaller endowments. Large endowments have the ability to be a liquidity provider, so they can essentially get phone calls at times to write a check and invest directly, which is an opportunity the smaller endowments do not have. Large endowments also get better fees and have more staff.

But being small does have some advantages. I have hired people with no experience, former students, and then trained them and made them feel that they were part of a startup, which we were. And I hope, they get to enjoy a great environment.

**Question:** How much patience do you have with an underperforming manager if your qualitative evaluation and conviction in the manager are unchanged?

**Kochard:** I turned over the portfolio substantially, with the exception of two managers, when I started at Georgetown. But I have yet to terminate one of the managers we have hired. That is not to say we have not had underperforming managers. Managers who are underperforming get an extra degree of scrutiny.

**Question:** What's your favorite "outside-the-box" due diligence question for a private equity or venture manager?

**Kochard:** I wouldn't point to a single question but rather multiple questions that revolve around the manager as a person. Where did the individual grow up? What sports and movies does the person like? I am trying to get a sense of the whole person because I want to know if this is someone I want to spend time with. One mistake I made once was to hire a couple of managers who, frankly, were arrogant. I did not like them, but I knew they were supposed to be really smart. I came to regret that decision to hire them.

**Question:** Can you comment on the endowment/foundation perspective on socially responsible investing?

**Kochard:** At Georgetown, our investment policy statement is worded to the effect that the board of directors can elect to exclude certain securities that are inconsistent with the Catholic identity of the institution, which is fairly broad. That has been invoked only one time, and that was during the apartheid era.

That said, you need to be sensitive to "hot-button" issues that concern the students and faculty. Right now, one such issue is Darfur. One of the national groups focusing on Darfur was started at Georgetown. So, it is an issue near and dear to the university. We've tried very hard to work with the student group to assure them we do not own securities directly in Darfur. We also talk to our managers to bring their attention to this issue, and we have made public statements to let others know that this issue is on our mind.

Being sensitive to such issues is part of the process of building a relationship with the institution. It gets back to the point that we're not investing our own money. We're investing somebody else's money. And to be successful, we have to understand the institutional constraints.