Partners Capital, LLP
5 Young Street, 5th Floor
London, W8 5EH
Tel: +44 207 938 5200
Fax: +1 617 292 2571

Challenges to the Endowment Model

The content below is a summary of the conclusions from a panel discussion held at the Partners Capital 2017 Annual Client Meeting in New York City on the 11th of October.

The topic of the panel discussion was:

Is the Endowment Model still the best institutional investment approach?

Left to right below: Suzanne Streeter (Head of Private Markets, Partners Capital, formerly with Yale University Endowment), André Perold (CIO, HighVista Strategies and former Harvard Business School professor of Finance), Jason Klein (CIO, Memorial Sloan Kettering Foundation), Bob Peck (Managing Director, FPR Partners; Board Member, Princeton University Investment Company), and Paul Dimitruk (Chairman and Partner, Partners Capital).

The Endowment Model is a multi-asset class investment approach, characterized by allocations to private equity and other alternative asset classes, that has become increasingly popular over the last few decades. More recently, the following challenges have had many investors questioning the future viability of the model:

- The uninterrupted and simultaneous robust performance of domestic equities and fixed income (e.g., the 60/40 equities/bond portfolio has outperformed even Yale)
- The growing popularity of the endowment model across all pools of assets, including not just endowments and foundations, but family offices and pension funds
- Significant amounts of capital raised by Private Equity asset managers, and
- The elevated valuations across a number of alternative asset classes (e.g., private equity, property, etc.

Below we summarize the questions posed to the panel and their responses.

Question 1: How do you define the Endowment Model?

(André Perold) - The Endowment Model is how one can generate investment returns in excess of those achieved through index investing, searching for and identifying sources of alpha with no asset class, geographic, or sector constraints.

(Bob Peck) - In addition to having an infinite duration as it relates to assets, endowments also take a long-term approach to staffing and relationships. An aspect of the Endowment Model is becoming very good at choosing long-term partner relationships.

(Jason Klein) - The Endowment Model comes down to four things: a disciplined investment methodology, an alignment of interests, a pro-growth orientation, and a research-driven approach to taking advantage of market inefficiencies.

(Paul Dimitruk) - A fundamental tenant of successful endowment investing is having plenty of courage, patience, and resolve during market crises and the willingness and ability to stay the course. The Endowment Model is also continuously seeking out less-competed, more value-added investment strategies.

Question 2: Can you describe what you view as the challenges to the Endowment Model, particularly given the competitive nature of trying to access niche strategies?

(Bob Peck) - Not only have returns and arguably the markets overall become more challenged, competition amongst endowments has increased. When ideas become well-known and widespread, you have to continue to evolve. The last few years have not been particularly healthy for active management or diversification which may create challenges for groups that may not have as much institutional backing, potentially leading to pressure around how long-term is a long-term endowment.

(Jason Klein) - There are three primary challenges:

1. Misplaced expectations: Grounding expectations in the experience from the mid-1990s through 2008 - a period that coincided with the birth of Private Equity, the peak of Venture Capital, the emergence of Emerging Markets, the decline in interest rates from the high teens to zero, and the opportunity to establish relationships with what proved to be the top performing managers - is a little bit misplaced.
2. Starting valuations: For any equity-oriented or pro-growth portfolio, elevated valuations are a risk for the next few years.
3. Potentially bifurcated outcomes: If any one concentrated opportunity set dominates, as the S&P 500 and indexing have done in recent years, a diversified portfolio won't look good in retrospect.

(André Perold) - The 60/40 equity/bond portfolio is currently priced to generate a 3% real return compared to its historical average of 5%, so there is a gap to fill. Unless you want to take more risk and allocate your entire portfolio to equities (currently priced to generate a 5% real return), you need to find sources of alpha which is a challenging proposition. Alpha in public markets has to be harder to come by. The challenging environment today stems from the shift of unsophisticated investors toward indexing and away from trading individual securities. Sophisticated investors now must beat other sophisticated investors to outperform. The private markets are more hospitable to alpha, whereby asset managers can internalize more of the benefits for themselves compared to the free loading that occurs in the public markets.

(Paul Dimitruk) - There are potential ways to meet the challenges identified by the other panellists:

1. Maintain the courage and the resources to explore and evaluate alternative alternatives which are off the beaten path opportunities that are outside and uncorrelated with the conventional capital markets.
2. Discern the difference between managers that have lost their way and those that are temporarily off their game.
3. Exploit the growing transparency in the asset management world by securing more favourable terms, including lower fees, longer-lock share classes with lower fees, and access to parallel co-investment funds.
4. Value and listen to the experience and leadership of the Investment Committee members, many of whom have decades of market memory and insight into what has worked and what has not worked in the past.

Questions from the audience:

What is the appropriate composition of an Investment Committee?

(André Perold) - The make-up of the committee should be matched with the investment strategy with more complex strategies requiring bigger and more sophisticated teams; asset allocation capabilities are also a requirement.

(Paul Dimitruk) - Strong leadership is critical and strong advocates for change.

(Jason Klein) - The Investment Committee must understand its objective; managing the investment team or making investment decisions.

(Bob Peck) - Diversity of outlook; collective efforts to arrive at good outcomes.

How should the Endowment Model be adjusted for taxable investors?

(Paul Dimitruk) - Overall shape of the investment portfolio is not entirely different, but it is important to be aware of tax implications and seek more tax-efficient strategies.

Are 5% annual distributions realistic?

(Bob Peck) - 5% is a starting point, and it is important to think very long term.

(Jason Klein) - The 5% assumption was set by the IRS. You should think about the level of risk the Endowment is willing to take in deciding an appropriate target.

How does the Endowment Model take into consideration the macro forces discussed today?

(Bob Peck) - It is harder to have great confidence in long-term macro decisions compared to discreet manager decisions.
(Jason Klein) - Macro is hard, but it helps you understand and prepare for risk and potential investment implications. Maybe you do not act today, but you are prepared.

How is misalignment between GPs and LPs avoided?

(Jason Klein) - Our goal is to partner with great investment managers looking to create value and want patient value-add partners. You can also tailor a fee share that works for both parties over time.

(Paul Dimitruk) - Two-way value proposition whereby the investor provides intel as well as economics; alignment starts day one with character.

(Bob Peck) - We seek out alignment with management teams and our terms are an indication of alignment with long-term investors.