SERVŌ WEALTH MANAGEMENT
Simplify Complexity

JULY 2012

Factors in Focus

# Lessons From the Big Money

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Have you ever wondered what your investment strategy would be if you had a $100 million, $1 billion, or even $20 billion dollar portfolio? Sure, stocks and bonds work for the small investor, but at these levels of wealth there must be something beyond plain old public equity and debt markets, right? Evidence from a prominent pool of wealthy investors allows us to look into this further.

College and university endowments are extremely large investment funds that are designed to finance a portion of the operating or capital requirements for the associated institution. If you've ever received a donation request from your school, chances are you would be contributing to their endowment fund. The amount of money these funds manage is staggering—the largest 50 funds all have over $1 billion, with Harvard topping the list at over $30 billion.

**Table 1: Endowment Performance by Size**

| | % Return July 2001 - June 2011 |
|---|---|
| Schools with more than $1B | **+6.9%** |
| Schools with $500M to $1B | **+6.0%** |
| Schools with $100M to $500M | **+5.3%** |
| Schools with less than $100M | **+5.1%** |
| *Average of all Endowments* | **+5.6%** |
| *80/20 Market Index Portfolio* | **+5.8%** |
| *80/20 Diversified Index Portfolio* | **+9.4%** |

***80/20 Market Index Portfolio*** = 56% CRSP US 1-10 Index, 24% MSCI All Country World ex.US Index, 20% Barclays Aggregate Bond Index; rebalanced annually

***80/20 Diversified Index Portfolio*** = 16% CRSP US 1-10 Index, 16% DFA US Large Value Index, 24% DFA US Small Value Index, 8% DFA Int'l Large Value Index, 8% DFA Int'l Small Value Index, 8% DFA Emerging Market Value Index, 20% Citigroup 3-5YR World Government Bond Index (hedged); rebalanced annually

**Source:** DFA Returns 2.0, 2011 NACUBO Study of Endowment Results

Several months after each fiscal year, which runs from July to June, most endowments release detailed financial reports summarizing their returns over the previous twelve months and longer periods, as well as a breakdown of their target portfolio asset allocation. With access to the most sophisticated investment strategies imaginable and the top money managers in the world, you might think they would be able to generate stratospheric returns. An in-depth look at the results in Table 1 says otherwise.

Far from producing exceptional returns, the average college endowment grew at just +5.6% per year over the last 10 years. Even schools with more than $1 billion in assets produced less than 7% per year. As a group, these hundred million and billion dollar investment pools produced a lower return than a simple "total market" index portfolio consisting of 56% US stocks, 24% non-US stocks, and 20% in US bonds, which had a +5.8% return. They also lagged far behind a more diversified index portfolio of the same asset allocation that included additional diversification from smaller and more value oriented stocks and shorter-term, higher-quality global bonds, which produced a +9.4% result. And the superior results from the index portfolios were not due to greater risk. The worst year in recent memory, 2008-2009, saw the average college endowment decline about -19%, similar to the decline for the Market Index Portfolio and about 3% more than the Diversified Index Portfolio.

So if really big money investors like college and university endowments don't offer us any insight into how to generate returns above traditional stock and bond balanced portfolios, what else can we learn from them?

*The information on endowment performance and asset allocations referenced in this article for the latest year available (2011) can be found here: http://www.nacubo.org/Documents/research/2011_NCSE_Press_Release_Final_Embargo_1_31_12.pdf*

### *LESSON #1: Don't ignore the need for liquidity*

The biggest trend in endowment management over the last decade has been the move away from traditional stocks and bonds and towards "alternative assets" including hedge funds, private equity, venture capital, distressed debt, and "hard assets" such as commodities and real estate. But less in bonds means less liquidity. In 2008, this lack of traditional fixed income meant endowments were forced to sell stocks at fire sale prices to meet cash-flow demands due to the inaccessibility of most alternative assets, which often restrict withdrawals to quarterly or annual installments. To make matters worse, these alternatives also failed to protect the portfolio as well as traditional bonds in 2008 and contributed to declines of almost 30% for schools with heavy alternative allocations like Yale and Princeton.

For individual investors, this lack of liquidity is simply unacceptable. No one is pleased with the low yields and low expected returns on high quality bonds. But so long as maturities are kept short and credit quality is high, bonds provide a reliable source of funding for retirement income or unexpected cash-flow demands when economic conditions are poor and stocks have temporarily lost value.

### *LESSON #2: Take a pass on past performance*

Endowment management is run by committee. Dozens of CFAs work for the larger funds, and they view their role as uncovering tomorrow's superstar managers. But they rely on the same past returns as all other active mangers, despite the widely known fact that past performance may not be indicative of future results. Studies show that the above average returns of top tier managers do not persist beyond a year or two, and they eventually fall back to the pack or worse. Portfolio managers could of course avoid this mistake by recommending these endowments invest passively in low cost, broadly diversified index funds such as those managed by Dimensional Fund Advisors (DFA) and Vanguard, but then again such an approach does not require dozens of CFAs conducting countless hours worth of manager "due diligence" (which are basically in-depth studies of past performance, as well as subjective intangibles such as ethics and firm structure), so this recommendation is the equivalent of career suicide.

### *LESSON #3 : You aren't too big to be small*

One of the drawbacks to running a hundred million or billion dollar investment pool is the inaccessibility of certain asset classes. Very large investors are mostly prohibited from buying small and micro cap stocks (which should be part of a well diversified portfolio), and even many smaller mid cap stocks are off limits. Because of the enormous size of these funds, were they to invest in smaller stocks, they could find themselves with a minority ownership stake in the companies given the relatively small number of shares outstanding compared to bigger blue-chip companies like Exxon and Apple. Individuals with smaller portfolios don't have this same constraint, and are better positioned to capture the higher expected returns and diversification available from smaller companies at home and abroad through a well structured index fund.

### *LESSON #4: Think in terms of decades, not days*

As mentioned above, endowment returns are reported annually and are heavily scrutinized. If a school underperforms other schools or the market as a whole by a wide margin in any given year, there will be consequences. But in order to outperform the market, one must deviate from the market. Along with increased exposure to small companies mentioned in lesson #3, holding a larger-than-market percentage of the lowest priced value stocks has also produced market beating returns over time—*but not every year*. As investors have seen recently, value stocks can underperform growth stocks and the market in general by a wide margin from time to time. For a billion dollar college endowment that must answer for their annual results, this market "tracking error" can also be a career killer. With a portfolio that is value tilted, you will likely be vindicated with above average returns if you are patient, but to the endowment manager who is out of a job by the time they materialize, what good are they? Individual investors don't need to have a similar short-term focus. It shouldn't matter in the least bit if their small and value tilted portfolio underperforms the market for a few years. As Table 1 shows, this divergence in short-run returns could result in 3% or more in returns above the market over longer periods, a result that is well worth the wait.

Ultimately, the most successful investment strategies are often the simplest. But a look under the hood of even the largest investment pools in the world reveals a dizzying combination of complexity, opaqueness, and subpar active management. If the returns were significantly above the performance of capital markets available to everyone, then these risks might just be worth it. But if the last decade is any indication—they aren't, and individuals are better off sticking with broadly diversified public market stock and bond index portfolios based on their unique objectives.

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