

# Endowment Managers See Slim Pickings

Investment experts at NACUBO's recent Endowment Management Forum emphasized the need to reduce risks and exercise restraint.

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By Mimi Lord  
TIAA-CREF Institute

In the absence of imminent market threats and exciting new investment opportunities, reducing risks was a key topic at both the 2005 NACUBO Endowment Management Forum and the related University Endowment Summit presented by the Goldman Sachs Global Markets Institute. During the January conference in New York City, investors were privy to the advice of several leading pundits. Speaking to the theme of "Achieving Investment Success in a Low-Return Environment," presenters indicated that "achieving success" means avoiding big mistakes in today's market environment.

While many speakers offered less-than-lukewarm prospects for U.S. equities, two experts stood out as having more optimistic outlooks. Barton Biggs, managing partner of Traxis Partners LLC, predicted annualized domestic equity returns of 8–9 percent over the next three to five years. Abby Joseph Cohen, chief U.S. portfolio strategist and partner at the Goldman Sachs Global Markets Institute, revealed the firm's outlook that the S&P 500 "fair valuation" at year-end 2005 will be 1325, providing a return of approximately 10–11 percent.

## Economic Indicators and Trends

Cohen, a former Federal Reserve economist, characterized the U.S. economy as being in good condition and noted that trend productivity growth is favorable by historical standards. Conceding that the federal budget deficit of \$400 billion-plus is a concern, Cohen said that as a proportion of GDP, the deficit is comparable to that of many other countries and still considerably less than during the Reagan administration. However, she cautioned that further gains in the budget deficit could become worrisome. The huge U.S. foreign trade deficit is largely a reflection of the disequilibrium of economic growth around the world. Cohen noted that many foreign countries aren't capable of importing at the level of the United States because their economies aren't growing as fast as ours. In her estimation, however, these market factors are "commentary" to the real issues facing investors.

Cohen presented the Goldman Sachs Global Markets Institute's "model portfolio breakdown" for the S&P 500, revealing a preference for stocks that benefit from ongoing economic expansion. The firm suggests an allocation of 18 percent to information technology, an overweight of about 17 percent, and a deviation from the market benchmark of 15.4 percent. Cohen said the firm is also enthusiastic about industrials and consumer discretionary services stocks—dining, travel, and media—as consumers are expected to shift spending away from big-ticket items such as new homes and cars. Another attractive area of investments is health care.

## Balancing the Scale: Overvalued Assets

Cohen does not believe U.S. equities are overvalued given the low-inflation and high-productivity environment. Ben Inker, director of asset allocation at GMO LLC, disagrees, offering a foreboding prediction: "more pain to come." Inker argues that most asset classes are considerably overvalued and that investors are faced with an inevitable principle of capitalism: reversion to the mean. Inker is generally pessimistic about the outlook for U.S. equities, but he cited small-cap and value-oriented domestic equities as being particularly overpriced following an extended period of superior performance.

For six different asset classes, Inker first presented what he called “real returns at equilibrium prices”—annualized real returns (net of inflation) that consultants might project over the long term when starting at fair prices. He then showed the required drop in value if the assets immediately returned to fair value, after which the investments could provide equilibrium returns. Finally, Inker calculated the annualized returns expected over the next seven years if equilibrium pricing was attained more gradually. As Table 1 shows, the annualized returns over seven years would range from -2.4 percent for U.S. small-cap stocks to 6.2 percent for emerging equities.

GMO’s return projections for each asset class are based on expectations from four components of return: 1) change in price/earnings ratios; 2) change in profit margins; 3) real per-share sales growth; and 4) dividend yield. The firm estimates -1.5 percent annualized returns for the S&P 500 (U.S. large caps), which include negative contributions from compression of price/earnings ratios and profit margins, and positive inputs from sales growth and dividend yield. Inker’s outlook for U.S. equities is so negative that he has a net short position in his personal account. He quipped that he’s not in danger of firing himself for taking such an unconventional approach but that endowment investment officers would undertake considerable career risk by doing so.

## **In With the New, Out With the Old**

With the risk/return curve lower and flatter than normal, Inker recommended that investors move their “optimal portfolio” down the curve to a lower risk level to “decrease the risk of doing really badly.” Inker warned that in today’s market, it may not be possible for endowments to earn enough on a real-return basis to cover their 5–6 percent spending rate with conventional allocations to U.S. equities.

Inker did express enthusiasm for one asset class—timber—which he applauded for its diversification benefits, strong historical returns, and attractive yield. In addition, timber provides much greater visibility than most other assets because returns are directly tied to biological growth. “If you know what you paid and how fast the trees are going to grow, you know almost everything you need,” Inker said. Commodities also provide diversification benefits but tend to have considerably greater volatility than timber.

Strategists who compared domestic and international equities generally found prospects to be better abroad than at home. Biggs believes that the U.S. dollar will continue to decline, thus providing currency-effect returns on international investments of 200 to 300 basis points above the domestic-currency returns. He favors certain international real estate markets such as Japan, where, in his view, office properties are undervalued. As for emerging markets, Biggs thinks they will outperform most other asset classes until they reach a bubble and burst. Even Inker, who believes international equities are overvalued, said such investments offer better potential than domestic equities.

For the most part, the investment experts recommended paring back fixed-income allocations, particularly in the corporate and high-yield sectors where spreads have narrowed significantly as credit quality has improved in recent quarters. According to Dan Fuss, vice chairman of the board at Loomis, Sayles & Company, the country is in transition from a period of quite low interest rates that bottomed in June 2003 to a period of higher rates. “How long it will last and how high rates will go is unknown,” he said. Fuss added that even Treasury Inflation Protected Securities (TIPS) may come under pressure as the Treasury releases sizable new issues. Regardless, Fuss believes these assets will “do great” in the long term.

## **Evolving Alternative Assets**

Despite the notable lack of excitement for new investment opportunities, alternative assets generated buzz at this year’s forum. A few speakers suggested that “alternative” is no longer an accurate characterization since many of these asset classes are sufficiently common to now be considered traditional. Several participants also described the ambiguity of hedge funds. With so many different strategies falling under the hedge fund umbrella, these individuals suggested that it should no longer

be considered a distinct asset class. One speaker referred to hedge funds simply as a form of asset allocation and another called them merely “a compensation scheme.”

Regardless of nomenclature, multiple speakers contended that investments in hedge funds and private equity—both buyouts and venture capital—have become too crowded, thus diminishing return potential. Biggs warned that most private equity firms under-perform the S&P 500 and that risk levels have escalated with the increased practice of issuing junk bonds as part of exit strategies. “I’m convinced that private equity is the next bubble and that returns over the next five years will be disappointing,” he said.

Several participants expressed skepticism about hedge funds, particularly because of their high fees, but one manager believes hedge funds are “the future of active management.” Cliff Asness, managing and founding principal of AQR Capital Management, described two broad categories of hedge fund strategies: investment skill or “alpha” turned into an investable diversifying asset, and a set of nontraditional arbitrage strategies that either provide liquidity or take a risk for which they are paid a premium. Hedge funds use unique tools not viable with traditional assets—leverage, derivatives, and short-selling— to carry out these strategies. “Hedge funds are here to stay,” Asness observed. “It’s very possible that the model for the future will be index funds plus hedge funds.” Asness acknowledged, however, that hedge funds need to “grow up” in certain aspects and overcome some “dark sides” before attaining such a future.

## Who You Hire Matters

Two speakers highlighted the challenges facing campus investors when choosing managers. Louis Morrell, vice president of investments and treasurer of Wake Forest University, Winston-Salem, North Carolina, and William Spitz, vice chancellor for investment and treasurer of Vanderbilt University, Nashville, emphasized how critical it is to invest with top managers in the areas of private equity and hedge funds. Morrell and Spitz described the enormous disparity between top-quartile and bottom-quartile performers. When interviewing potential managers, Spitz stressed the importance of finding out if they have a competitive edge. “It’s who you hire that really matters,” he said. “With alternatives, you’ve got to have the right managers—with strong track records and risk management processes—or you’re better off not getting into (alternatives).” Morrell said he carefully reviews the managers of the leading endowments, as detailed in the annual NACUBO Endowment Study, especially when considering new alternative investments.

Inker suggested a “modest” proposal for institutional investments in hedge funds. Starting with a base case of zero hedge fund allocations, he urges investors to decide how much of the portfolio can be dedicated to the manager’s selection capabilities. “None is not an unreasonable answer, nor is 90 percent,” he said. While a mediocre hedge fund is “just wasting space in a portfolio,” Inker added that investors need to identify “top-quartile performers—55 or 60 percentile performers will do.”

## Proceed With Caution

Echoing concerns about the market environment, Verne Sedlacek, president and CEO of Commonfund, offered investment advice given the possibility that the United States may re-enter a period of higher inflation. Sedlacek illustrated the value of reallocating some portions of endowment portfolios into asset classes that perform better in such an environment. He discussed the advantages of taking 20 percent of a traditional portfolio and dividing it among commodities, private real estate, energy, and TIPS. He said such diversification costs very little in lost returns if inflation remains low but provides valuable relative returns in a real-return environment.

Sedlacek also advised endowment officers to reconsider their overall levels of liquidity. Given the long-term investment horizons for endowments, he suggested that liquidity levels are unnecessarily high. Sedlacek cited studies indicating positive correlations between low-liquidity investments and above-average returns.

Other speakers highlighted the importance of planning and analysis. Andrew Golden, president of Princeton University Investment Company, recommended categorizing investment decisions into horizon buckets. Alluding to “The Serenity Prayer,” Golden asked to be granted “the wisdom to differentiate the secular and the cyclical and the strength and courage to act accordingly.”

Following a year of growth for most institutional endowments, Inker also recommended exercising restraint in endowment spending. “Enjoy the money (from recent endowment gains), but do not assume the good times are here to stay,” he said. “If it is possible to reduce the payout percentage, do it.”

Lest investors were unconvinced about the merits of timber investments, Spitz provided compelling arguments based on evidence from the 1987–2004 investing period. During this period, timber experienced higher annualized returns than the S&P 500 (14.9 percent versus 11.9 percent); greater diversification; reduced volatility; and greater inflation protection, especially during rising inflation. Spitz cautioned that, despite his enthusiasm, many professional timber management firms have entered the market in recent years and the saturation could dampen returns in the future. And like any asset, investors must bear in mind that past performance is no guarantee of future performance.

Mimi Lord is associate director at the TIAA-CREF Institute.

**Table 1. Equilibrium Returns Versus GMO Forecasts**

Asset Class	Real Returns at Equilibrium Prices	Immediate Gain/Loss to Reach Fair Value	Expected Annual Real Return to Reach Fair Value in 7 Years
U.S. Large Caps	5.7%	-37.0%	-1.5%
U.S. Small Caps	6.7%	-44.0%	-2.4%
Int'l Large Caps	5.7%	-15.0%	3.1%
Int'l Small Caps	6.2%	-16.0%	3.0%
Emerging Equities	6.7%	-2.0%	6.2%
U.S. Bonds	3.0%	-8.0%	1.5%