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# TRENDS AND ISSUES

## *2005 NACUBO Endowment Study: Highlights and Trends*

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# TRENDS AND ISSUES

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## EXECUTIVE SUMMARY

During the fiscal year ended June 30, 2005, college and university endowments earned an average rate of return of 9.3%, matching their 10-year annualized rate of return on an equal-weighted basis. The 9.3% overall rate exceeded that of typical equity benchmarks (S&P 500, 6.3%; and Russell 3000, 8.1%) as well as the Lehman Brothers Aggregate Bond Index, 6.8%. Overall, endowments with significant diversification beyond domestic equities and fixed income fared the best, and especially if they had above-average allocations to such stellar performers as real estate, natural resources and private equity. International equities and fixed income also had a very strong year. Large endowments for the most part outperformed small endowments, due to their greater allocation to alternative investments and to their ability to earn considerably more on alternatives than their smaller counterparts.

*TIAA-CREF administers the annual NACUBO Endowment Study on behalf of NACUBO.*

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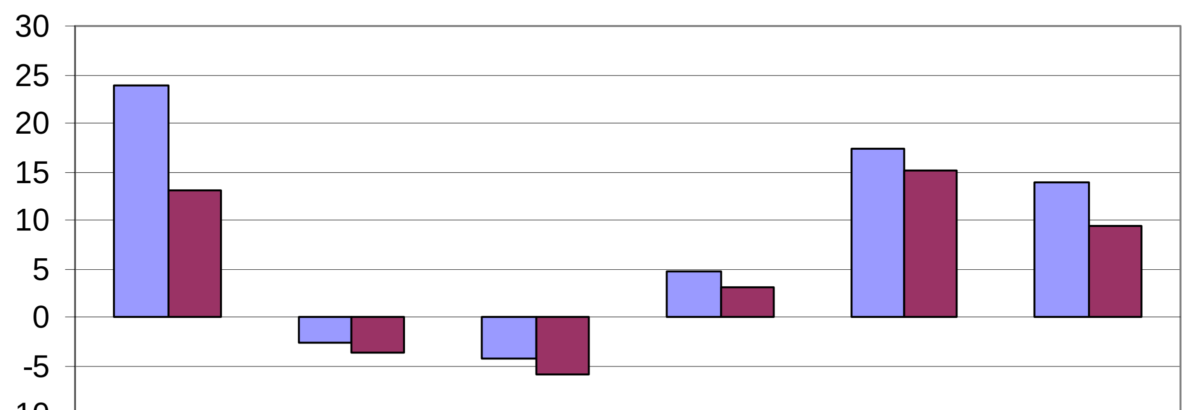
## 2005 Performance and Participants

An interesting aspect of the 2005 NACUBO Endowment Study (NES) is that the equal-weighted one-year performance of 9.3% is exactly the same as the 10-year compounded return of 9.3%. After several years of widely varying returns, fiscal 2005 results probably felt pretty comfortable to most campus investment officers and administrators. The graph below shows returns over the past six years on both an equal-weighted and dollar-weighted basis. Following exceptionally strong results in fiscal 2000, endowments posted two consecutive years of losses. In fiscal 2003, endowments posted smallish positive returns and then reaped sizable gains in 2004. The dollar-weighted returns, which are influenced more heavily by the larger endowments, are consistently stronger than the equal-weighted returns that are simple averages based on the number of participants.

**2000-2005 Fiscal Returns (%)**

***(Dollar-Weighted and Equal-Weighted)***



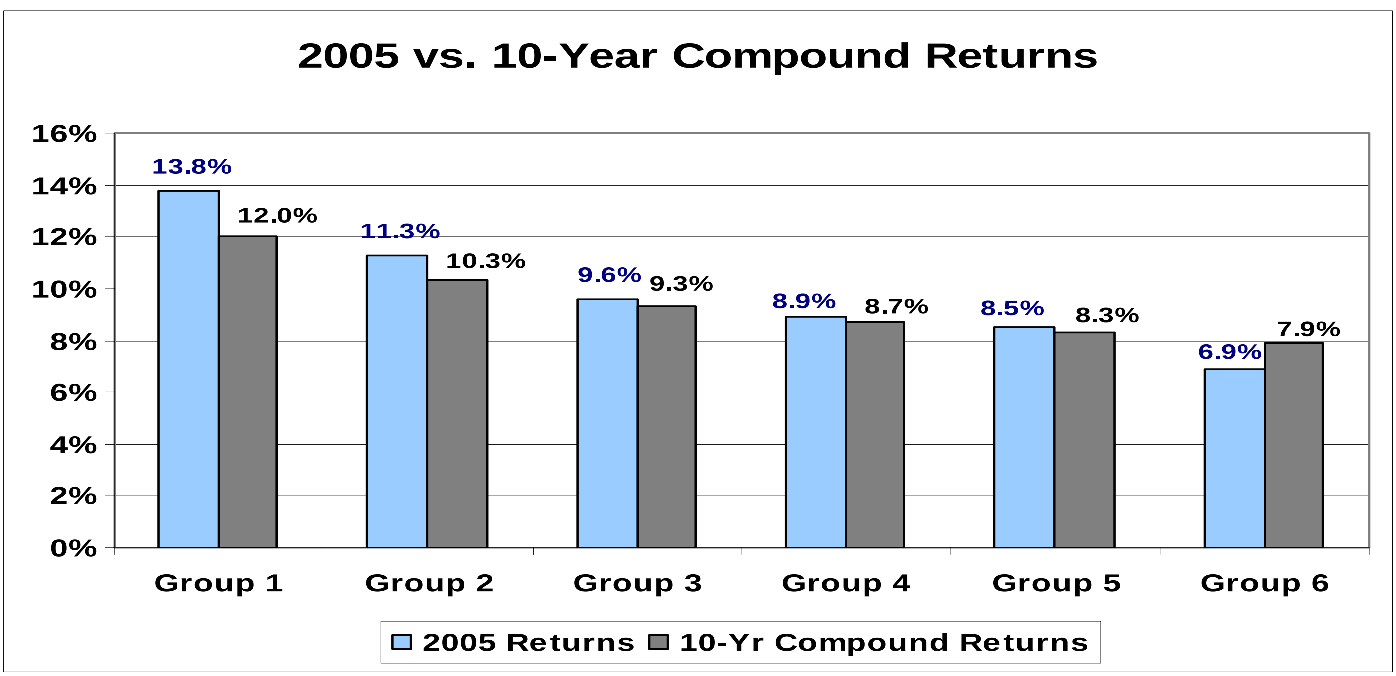

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|
| $-Weighted | 23.8 | -2.7 | -4.2 | 4.7 | 17.4 | 13.9 |
| Equal-Weighted | 13 | -3.6 | -6 | 3 | 15.1 | 9.3 |

The NACUBO study provides much of its data in four ways: 1) equal-weighted; 2) dollar-weighted; 3) by size categories; and 4) by public or independent (private) status. The following table shows the six categories or groups of endowments, ranging from Group 1 endowments with more than $1 billion in assets to Group 6 endowments with less than $25 million in assets. As investment returns and gifts to endowments exceed withdrawals, total endowment dollars increase as well as the number of endowments making the $1 billion-plus group. The number of endowments with assets of more than $1 billion reached 56 in fiscal 2005, up considerably from 39 just two years ago in fiscal 2003. Group 1 endowments now represent 65.1% of all assets in the study, compared to 58% two years earlier.

**2005 Groups by Endowment Size**

| Group | Endowment Size | # Inst. | % Inst. | % All $ | $/student |
|---|---|---|---|---|---|
| 1 | >$1 bil | 56 | 7.5% | 65.1% | $128,066 |
| 2 | $501 mil- $1 bil | 54 | 7.2% | 12.4% | $42,046 |
| 3 | $101 mil-$500 mil | 224 | 30.0% | 17.0% | $24,025 |
| 4 | $51 mill-$100 mil | 142 | 19.0% | 3.3% | $11,935 |
| 5 | $26 mil-$50 mil | 136 | 18.2% | 1.7% | $7,465 |
| 6 | <$25 mil | 134 | 18% | .6% | $2.311 |
| **Total** | **$299 billion** | **746** | **100%** | **100%** | **$43,804** |

As indicated, the endowment value per student differs enormously from an average of $128,066 among Group 1 endowments to an average of only $2,311 among Group 6. A total of 746 institutions participated in the 2005 study, representing total assets of $299 billion. The graph below shows the 2005 returns and the 10-year compounded returns of each of the six groups, revealing remarkable similarity although 2005 returns were, for the most part, slightly higher than the longer-term results. Group 6, the exception, had lower returns in 2005 compared to its longer-term average.



In an interesting coincidence of percentages, 72 percent of all students represented in the survey attend public institutions and 28 percent attend private institutions. However, the endowment pools have the opposite percentages, with 72% of total endowment assets held at private institutions and 28% at public institutions. Although the average endowment at an independent institution is only about 15% larger than the average endowment at a public institution, the fact that public institutions serve far more students results in an average endowment per student at private institutions that is more than six times larger than that at public institutions, $111,629 versus $17,195.

**2005 Study Participants by Public and Independent**

| | Public | Independent | All |
|---|---|---|---|
| Participants in Study | 231 | 515 | 746 |
| Avg. Student Enrollment | 21,271 | 3,727 | 9,143 |
| % of All Students | 72% | 28% | 100% |
| % of Total Endowment $ | 28% | 72% | 100% |
| Endowment $ per Student | $17,195 | $111,629 | $43,804 |

Participants are also described in the study by their Carnegie Classification, which refers to the highest level of degree that is offered broadly at an institution. As shown below, doctoral/research, master's, and bachelor's degree institutions each represent slightly more than 30% of total participants, while community college and specialized institutions represent far smaller percentages.

**2005 Participants by Carnegie Classification**

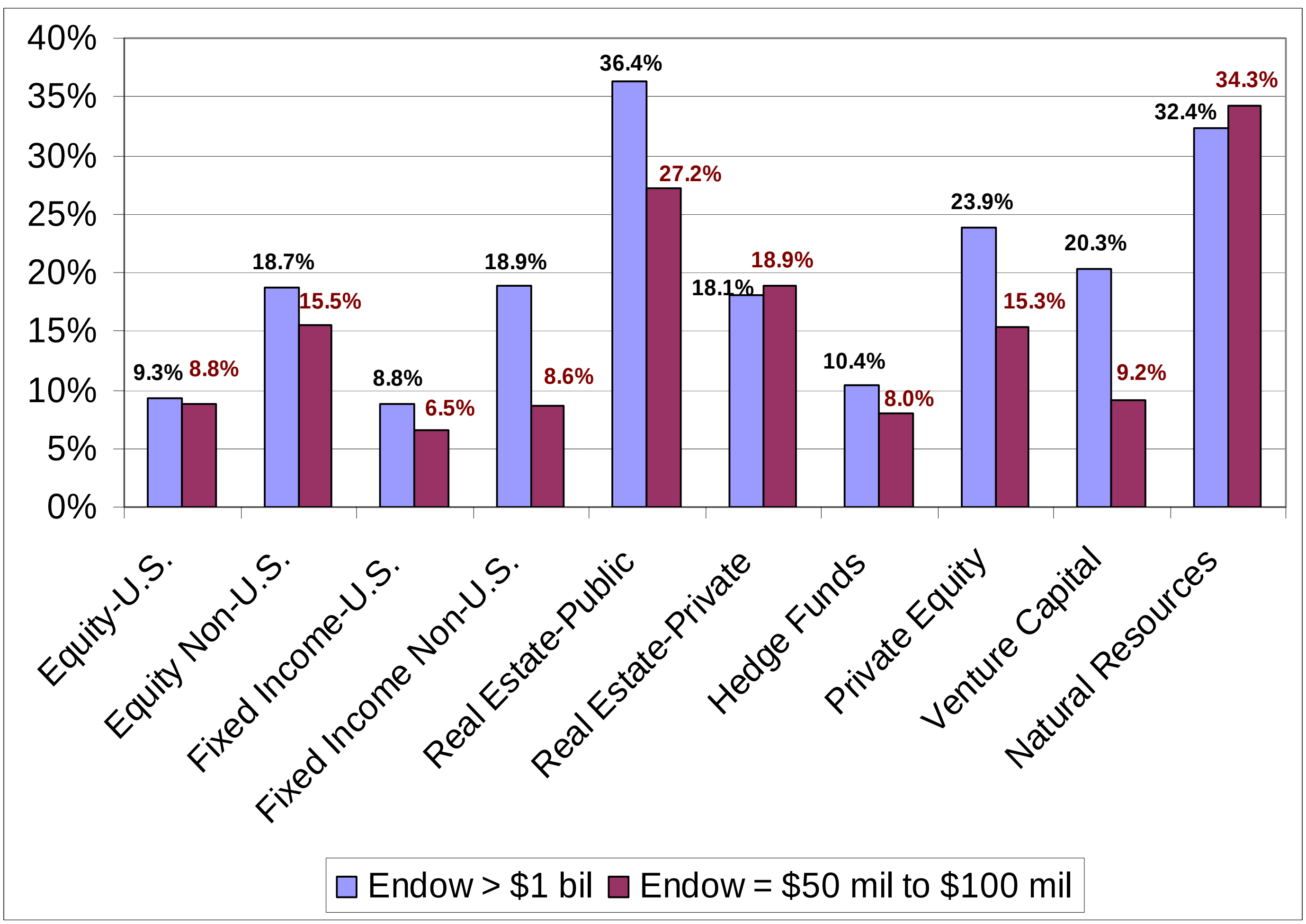
| | Number of Participants | Average Enrollment | Endowment per Student |
|---|---|---|---|
| **Doctoral/ Research** | 226 | 20,390 | $51,308 |
| **Master's** | 239 | 5,932 | $13,595 |
| **Bachelor's** | 231 | 1,878 | $90,583 |
| **Community College** | 19 | 17,614 | $985 |
| **Specialized** | 31 | 1,218 | $108,189 |

## Returns by Asset Class

The study provides returns by asset class according to the six size categories of endowments. Returns within certain alternative asset classes varied considerably between large and small endowments in fiscal 2005. The markets for alternative investments are less efficient than conventional markets and thus tend to favor larger endowments with bigger research staffs, better connections and greater buying power than smaller endowments. The graph below shows the average returns by asset class of Group 1 endowments (more than $1 billion in assets) compared to Group 4 endowments ($50 million to $100 million). Whereas the discrepancy in returns is quite small within domestic equities, 9.3% compared to 8.8%, it is enormous in less traditional asset classes such as venture capital, 20.3% compared to 9.2%; and private equity, 23.9% compared to 15.3%. Venture capital returns got a big boost from Google's initial public offering in August 2004. Interestingly, the group of smaller endowments eked out slightly higher returns than their big brethren in natural resources and private real estate. (Note that less than 10 endowments out of 142 in the category of smaller endowments actually reported holding any natural resources, which had a banner year thanks in part to soaring energy prices.)

**2005 Returns by Asset Class**

*(Comparison of Endowments >$1 billion and those $50 million to $100 million)*

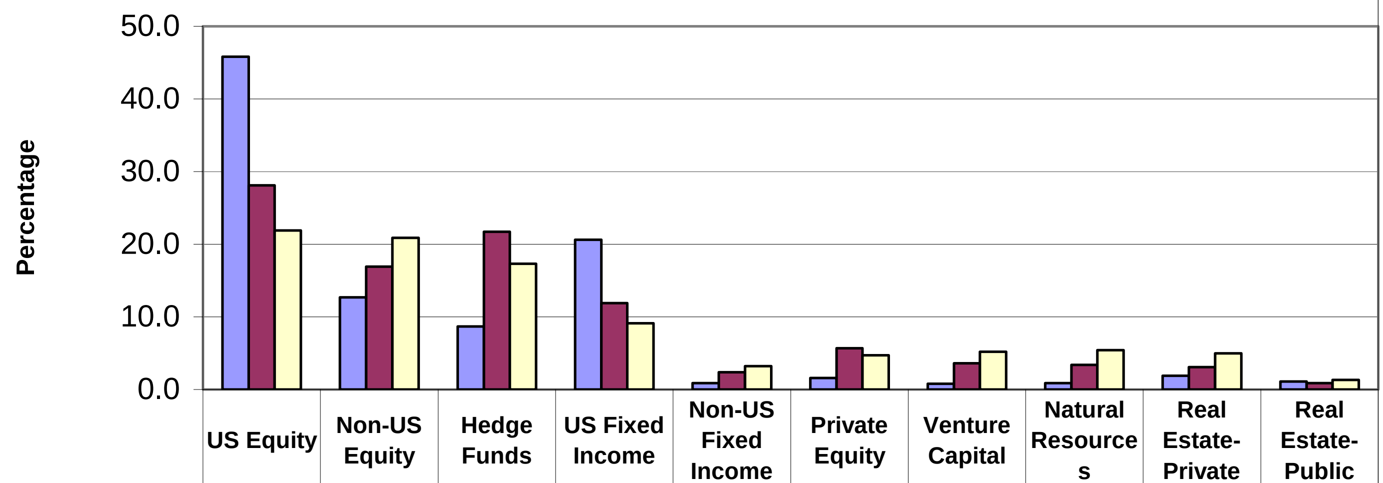


Given that alternative investments produced very strong results overall in fiscal 2005, it is not surprising that the best performers had above-average allocations to alternatives. The top 10 performers in 2005 earned an average return of 20%, compared to the 9.3% equally weighted return of all participants with a June 30 fiscal year. The following graph shows just how differently the top performers of fiscal 2005 are invested compared to the average endowment. Note that the top performers have less than half the allocations to domestic equities and fixed income than the average endowment, but far greater allocations than average to international and alternative investments. (Only eight of the top-10 performers provided their asset allocations in the recent survey, so the average allocations of those eight are compared with the equally weighted average of all participants.)

Also shown are the average asset allocations of the Group 1 endowments with more than $1 billion in assets. In most instances, the top performers have larger allocations to alternatives than the average endowment and even the Group 1 endowments, and considerably smaller allocations to domestic equities and fixed income. In hedge funds and private equity, however, Group 1 endowments had somewhat higher allocations than the average of eight top performers. Hedge fund returns did not keep pace with other alternative investment returns in 2005, partly because reduced volatility in equities did not provide as much opportunity for outsized returns in long-short strategies as in certain previous years.

**Asset Allocations, June 30, 2005**

*(Equal-Weighted, Group 1, and Top Performers)*

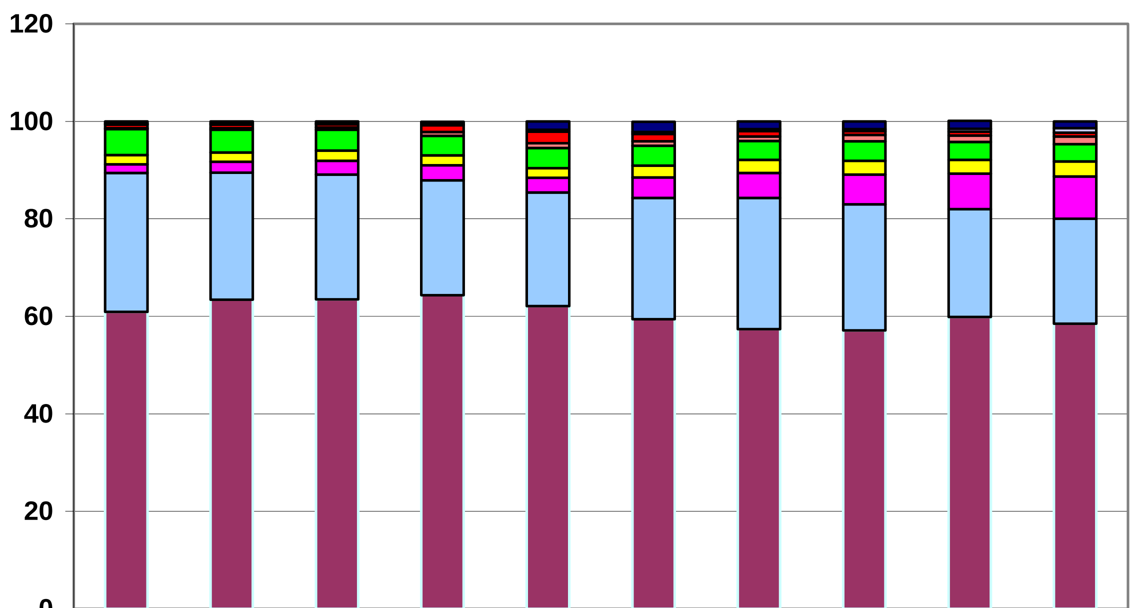



| | US Equity | Non-US Equity | Hedge Funds | US Fixed Income | Non-US Fixed Income | Private Equity | Venture Capital | Natural Resources | Real Estate-Private | Real Estate-Public |
|---|---|---|---|---|---|---|---|---|---|---|
| Equal Wtd | 45.8 | 12.7 | 8.7 | 20.6 | 0.9 | 1.6 | 0.8 | 0.9 | 1.9 | 1.1 |
| Group 1 | 28.1 | 16.9 | 21.7 | 11.9 | 2.4 | 5.7 | 3.6 | 3.4 | 3.1 | 0.9 |
| Avg. of 8 | 21.9 | 20.9 | 17.3 | 9.1 | 3.2 | 4.7 | 5.2 | 5.4 | 5.0 | 1.3 |

## Trends in Asset Allocation

An analysis of asset allocation over longer periods reveals a gradual shift out of conventional equities and fixed income, and a gradual shift into alternative investments and particularly hedge funds. The following graph shows the equal-weighted asset allocations over the past 10 years. Note that fixed-income allocations declined from 28.5% in 1996 to 21.5% in 2005, and that hedge-fund allocations increased from 1.8% in 1996 to 8.7% in 2005.

**Asset Allocations, 1996-2005, Equal-weighted**




| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|
| Other | 0.5 | 0.4 | 0.4 | 0.5 | 1.7 | 2.1 | 1.6 | 1.6 | 1.6 | 1.4 |
| Natural Resources | 0.2 | 0.3 | 0.2 | 0.2 | 0.4 | 0.4 | 0.4 | 0.4 | 0.6 | 0.9 |
| Venture Capital | 0.7 | 0.7 | 0.7 | 1.4 | 2.4 | 1.5 | 1.1 | 0.8 | 0.8 | 0.8 |
| Private Equity | 0.2 | 0.3 | 0.4 | 0.8 | 1 | 0.9 | 0.9 | 1.3 | 1.3 | 1.6 |
| Cash | 5.3 | 4.7 | 4.3 | 4 | 4.1 | 4.1 | 3.9 | 4 | 3.7 | 3.5 |
| Real Estate | 1.9 | 1.9 | 2.1 | 2 | 2 | 2.4 | 2.7 | 2.8 | 2.8 | 3.1 |
| Hedge Funds | 1.8 | 2.2 | 2.8 | 3.1 | 3 | 4.2 | 5.1 | 6.1 | 7.3 | 8.7 |
| Fixed Income | 28.5 | 26.1 | 25.6 | 23.6 | 23.3 | 24.9 | 26.9 | 25.9 | 22.1 | 21.5 |
| Equity | 60.9 | 63.4 | 63.5 | 64.3 | 62.1 | 59.4 | 57.4 | 57.1 | 59.9 | 58.5 |

## Responsibility over Investment Decisions

In a new section of the endowment study for 2005, participants were asked which person or group is responsible for certain investment management decisions. The table below lists the six types of decisions, and the percentage of participants indicating that their investment committees are responsible for those decisions. (The other possible responses were: chief investment officer, governing board, investment professionals, or others.)

| Investment Management Decision | % Indicating Investment Committee |
|---|---|
| Hiring Managers | 76.8% |
| Firing Managers | 76.9% |
| Spending Policy Changes | 52.7% |
| Asset Allocation Decisions | 80.1% |
| Investment Objectives | 78.9% |
| Social Responsibility Objectives | 69.0% |

The two areas where governing boards are more involved than in other decision-making areas are spending policy changes, 42.6%, and establishing social responsibility criteria, 23.3% In the area of hiring and firing managers, chief investment officers make the decisions at about 38% of the endowments with more than $1 billion in assets, compared to only about 6% at institutions overall.

## Spending Rates

Largely because of recent endowment gains, the average spending rate declined to 4.7% in fiscal 2005, compared to 5.0% in 2004 and 5.1% in 2003. The spending rate is calculated as the dollar amount made available for spending as a percentage of the market value of the endowment at the beginning of the recent fiscal year. The most commonly used spending rule is 5% of assets based on an average of the three most recent years. Therefore, when financial markets are strong and endowment values are trending upward, spending rates decline under that rule. Conversely, when endowment values are declining, spending rates generally increase.

## Summary

In sum, fiscal 2005 was a commendable year for college and university endowments and one that more closely resembled long-term historical returns than we've seen in a number of years. The year provided handsome returns to those endowments with oversized allocations to certain alternative investments and, once again, demonstrated the benefits of diversification. When the economy and financial markets plummeted earlier in the decade, state appropriations also fell and public institutions found it necessary to impose significant tuition hikes, averaging 6.9% from fiscal year 2000-01 to 2005-06, according to The College Board. However, institutions now have experienced three consecutive years of positive investment returns and an overall increase in 2005 state appropriations. Perhaps there's hope for sustained "normal" returns, or at least ones that resemble long-term averages.

For more information about the 2005 NACUBO Endowment Study, please go to NACUBO's web site, http://www.nacubo.org/x7616.xml.

## About the Author

Mimi Lord, Associate Director of the TIAA-CREF Institute, writes frequently on endowments and investment-related topics. A Chartered Financial Analyst and Certified Financial Planner, Ms. Lord previously worked as a portfolio manager and financial advisor.