In the nonprofit community, the centrality of asset allocation to contemporary investment policies and decision making is universally accepted. Of all the decisions made by the investment committees of educational endowments, private/independent foundations, and operating charities (the latter comprising cultural, religious, and social service organizations), none is seen as more impactful than asset allocation.

Although some investment practices are relatively recent—for instance, the enormous growth of exchange-traded funds and liquid alternatives—contemporary thinking regarding asset allocation is not something to have emerged quickly. Instead, it evolved over an extended period of time, beginning with a particularly fertile era more than a half century ago. Thus, before looking at current trends in asset allocation across this range of nonprofit institutions, providing historical context will help readers understand how current thinking evolved as well as the forces that shaped it.

The Foundations of Contemporary Practice
Going back to the 1960s, traditional endowment management was guided by thinking rooted in the principles of personal trusts. Spending was tied to the yield generated by the endowment, resulting in a bias toward fixed-income instruments. Concepts such as total return and market value accounting were only beginning to emerge. Returns from college endowments persistently lagged the rate of growth in operating budgets.

A Landmark Study in 1967
One of the landmark studies that began to change thinking was “Managing Educational Endowments,” commissioned by the Ford Foundation and authored by Robert R. Barker, a member of the Smith College investment committee, in 1967. The Barker report tied poor investment results to the effort to avoid losses and the emphasis on current income. It recommended that colleges base spending on a formula, e.g., 5 percent of a moving three-year average of the endowment’s value.

Another milestone study commissioned by the Ford Foundation was “The Law and the Lore of Endowment Funds,” by William Cary, a former chair of the Securities and Exchange Commission, and Craig Bright, a New York attorney, in 1969. Among its key conclusions were that endowments are not subject to traditional trust law concepts that apply to trusts for individuals, and that trustees could employ professional investment managers and delegate to them the responsibility to manage investments within guidelines established by the trustees. Cary and Bright also noted wide differences in state laws and suggested the need for uniformity.

In the first study of educational endowments . . . participating institutions reported an average allocation to alternatives of 23 percent. In the most recent study . . . that had risen to 53 percent—more than half the average study participant’s portfolio (on a dollar-weighted basis). This recommendation came to pass in 1972 when the Uniform Management of Institutional Funds Act (UMIFA) was approved by the National Conference of Commissioners on Uniform State Laws and ultimately enacted by 47 states. UMIFA established standards for the management, investment, and expenditure of the endowment funds of nonprofit institutions. UMIFA changed colleges’ widespread use of book value accounting, which simply recorded the original cost of portfolio securities and disregarded subsequent changes in market value unless a security was sold. In this way, return had been considered to be investment income from dividends and interest, plus or minus realized gains or losses from any securities that were sold. This also tended to bias trustees in favor of investing in bonds and in stocks that paid relatively high dividends. Under UMIFA, an institution could spend from an endowment fund up to the amount of appreciation above the historic dollar value but could not spend below this historic dollar value.

In 1986, what is perhaps the seminal study of asset allocation, “Determinants of Portfolio Performance,” was published by
nonprofits recognized that asset allocation was central to their ability to fulfill their mission over time. Thus, nonprofit institutions played a key role in shaping asset allocation strategies that are broadly accepted not only in the institutional world, but also among individual investors everywhere.

Sources of Asset Allocation Data
Absent reliable data, asset allocation practices might be observed on a spot or anecdotal basis but not trended over time. Fortunately, a set of studies tracks asset allocation trends across the nonprofit sector over the past decade. The data have been collected and analyzed through separate annual studies of educational endowments, private foundations, and operating charities going back as far as the 2000 fiscal year.

The studies—all designed and implemented by experienced and knowledgeable survey research professionals—have been sponsored by Commonfund, an organization that has managed endowment and operating funds for nonprofits since 1971. Specifically, the studies were conducted under the auspices of the research and publishing arm of Commonfund, the Commonfund Institute, whose mission is the promulgation of best practices in investment management and governance across the nonprofit sector.

The first study of educational endowments was released in 2001 (for the 2000 fiscal year) as the Commonfund Benchmarks Study® Educational Endowment Report. It was conducted every year until 2009, when Commonfund teamed with the National Association of College and University Business Officers (NACUBO) to publish the NACUBO-Commonfund Study of Endowments® (NCSE). This partnership expanded an already-large nationwide study to today’s research universe of more than 800 public and private colleges and universities.

The study of private/independent foundations was launched in 2002 and followed a similar pattern of being conducted by Commonfund Institute until 2012, when Commonfund and the Council on Foundations partnered to create the Commonfund-Council on Foundations (CCSF) Study of Investments for Private Foundations®.

Initially, foundations and operating charities were combined in the same study. Recognizing the distinct difference between these two types of nonprofits, however, Commonfund Institute began publishing a separate study of operating charities in 2006 and it continues today as the Commonfund Benchmarks Study® Operating Charities Report.

To distinguish between the practices and policies of institutions with varying sizes of endowments, all the studies segment participating organizations into size cohorts (e.g., institutions with assets of more than $1 billion, institutions with assets of less than $25 million, and so forth). The studies also segment participants by type: for instance, public versus private colleges and universities and, among operating charities, cultural, religious, and social service organizations. The foundation and operating charity studies collect and analyze data for years beginning January 1 and ending December 31, and the educational endowment study aligns with the practice of most educational institutions by beginning the fiscal year on July 1 and ending it the following June 30.

Patterns of Asset Allocation
In terms of asset allocation, the megatrends to emerge over the years the studies have been conducted are the following:

- A steady increase in allocations to alternative strategies
- Decreases in allocations to domestic equities and fixed income
- Relative stability in the size of international equity allocations

Figure 1 shows comparative data from the three studies that illustrate 10-year trends (2004–2013) in allocations among major asset classes and strategies.

Before examining trends in allocations to specific asset classes and strategies, it is important to point out that, with only a few
exceptions, larger nonprofit institutions have earned higher investment returns than their smaller counterparts. Of course, along with portfolio diversification in the interest of risk reduction, higher returns are the objective that drives asset allocation decisions. Several factors account for large institutions’ better relative performance. A primary one is their adherence to the tenets of the previously mentioned endowment model, which is reflected in their greater overall allocation to equities, especially less liquid alternative strategies. Larger endowments also have greater internal resources, principally larger staffs. But large staff size—of say, five or more people—is usually found only among the largest endowments with assets of more than $1 billion. For all others, only one full-time equivalent staff member is charged with tending to the endowment—and in many cases, that staff member has additional financial management duties, meaning endowment management is but part of the larger job description.

**Alternative Investment Strategies**

Turning to specific allocations, the rise of alternative investment strategies can be captured in a single statistic. In the first study of educational endowments, for FY2000, participating institutions reported an average allocation to alternatives of 23 percent. In the most recent study, for FY2013, that had risen to 53 percent—more than half the average study participant’s portfolio (on a dollar-weighted basis). In between, with only slight interruptions, allocations to alternative strategies increased steadily from year to year. For foundations, similar data points (from the first study for 2003 to the most recent for 2013) show an increase from 14 percent to 42 percent. (Alternative strategies include marketable alternatives, such as hedge funds, absolute return, market neutral, long/short 130/30, event-driven, and derivatives; and private capital, including private equity, international private equity, global venture capital, and natural resources; distressed debt; and private equity real estate.)

Although the steady growth in allocations to alternative strategies is clear, it is uneven when the data are viewed by size of institution. In that first study of educational endowments, institutions with assets of more than $1 billion reported a 16-percent allocation to alternatives. Institutions with assets between $50 million and $100 million reported an allocation to alternatives of just 7 percent.

In the most recent NCSE, institutions with assets of more than $1 billion reported an average allocation to alternatives of 59 percent and those with assets between $50 million and $100 million had an average allocation to alternatives of 20 percent. Figure 2 highlights 10-year alternative
strategies allocation trends among educational endowments, foundations, and operating charities.

As has generally been true over the years, the allocation to alternatives correlates with the size of an institution, i.e., the larger the endowment, the greater the allocation to alternatives. This is consistent across six size cohorts in the NCSE for FY2013. Likely reasons include that larger institutions have greater resources, particularly larger staff size, to devote to managing alternative strategies, which are typically highly time-intensive. As well, these institutions may have more sophisticated and knowledgeable investment committees, including members with professional experience in alternatives. Another key—a critical one for success in alternative strategies—is access to the most skilled managers, because the return spread between first quartile and median alternatives managers is typically much wider than it is among publicly traded equities.

One warning sign for some institutions may be over-concentration in certain alternative strategies. This applies especially to marketable alternative strategies, and especially among smaller nonprofit investors. In the NCSE for FY2013, for example, educational endowments with assets between $25 million and $50 million committed 58 percent of their alternatives allocation to these strategies and another 17 percent to energy. That leaves only 25 percent for diversifying strategies ranging from venture capital and private equity to distressed debt and equity real estate.

The uninterrupted growth of alternatives allocations may reflect decision-makers’ awareness that it takes a decade to build a well-diversified alternatives portfolio. As noted, educational institutions led the way in alternative strategies, followed at some distance by foundations and operating charities. Despite the secular trend toward higher alternatives allocations, there were distinct cycles. In the early 2000s, for instance, private equity and venture capital flourished. But heavy inflows and excessive leverage led to unsustainable valuations and lowered returns. The flight to liquidity during the Great Recession also slowed the growth of allocations to alternatives, particularly private capital. But hedge funds retained their value relatively well during the height of the turmoil in 2008—declining about 12 percent versus the S&P 500’s 36-percent reversal—and discipline returned to the private capital market. Real estate also showed strong returns in the early part of the decade, but excesses in both commercial and residential real estate created a crisis that only recently has begun to be resolved.

Domestic and International Equities
Despite shrinking in size, allocations to traditional domestic equities remain an important component of the endowment model’s equity bias. But a U.S.-centric view has been broadened through allocations to international equities, including emerging markets—although developed international markets have not delivered as much of a diversification benefit as they did in the 1980s.

In the first educational endowment and foundation studies, allocations to domestic equities stood at 41 percent and 48 percent, respectively. In the most recent studies, those respective figures had shrunk to 16 percent and 24 percent. Once again, however, there is a significant disparity in allocations among institutions of varying sizes. In the original educational endowment study, allocations ranged from 35 percent among the largest institutions to 54 percent among the smallest. In the most recent study, the same allocations were 13 percent and 43 percent, respectively—a spread of 30 percentage points versus 19 percentage points in the earlier study.

Allocations to international equities have remained relatively steady through time and, if anything, have increased, reflecting nonprofit investors’ desire to diversify across developed markets and participate in the potential for higher returns from emerging markets.

Reviewing allocations to international equities, in FY2000 educational endowments allocated 14 percent; in FY2013, that figure had increased to 18 percent. In FY2002, foundations allocated an average of 10 percent to the asset class; this had grown to 20 percent in the 2013 CCSE. Of note, international equities show the tightest spread in allocation size across size cohorts. For example, in the 2013 CCSE, the largest study participants allocated 20 percent to the asset class and the smallest allocated 21 percent.

Fixed Income
In addition to domestic equities, fixed income has been the source of most of the funds flowing into alternative strategies over the past decade. Fixed income remains a source of current income, an anchor to windward in a storm as well as a deflation hedge. Otherwise, however, this allocation has been less useful, particularly in a period of historically low interest rates.

Today, among educational endowments allocations to this asset class range from 8 percent among the largest endowments to 26 percent among the smallest; it is also another asset class whose allocation correlates with size of institution over the six size cohorts in the study. Overall, study participants allocated 10 percent to fixed income—less than half the 21 percent allocated in FY2000. In the first foundations study, fixed income received a 24 percent allocation from all study participants; in the most recent foundations study that had declined to just 9 percent.

Looking ahead, the asset class is viewed cautiously for two reasons: With rates so low, the only real directional move would be upward and a number of factors may cause inflation to heat up from recent relatively low levels.

Short-Term Securities/Cash
Less liquid alternative strategies exhibited the strongest growth over the decade, but the most liquid—cash and near-cash allocations—also grew. In the first study of educational endowments, this asset class claimed just 1 percent of the average endowment fund. In the most recent study, this had grown to 3 percent (it was actually 4 percent the year before that). Although appearing counterintuitive because these assets generate low to negative real returns—and serve
as a drag on portfolio returns during up markets—the previously mentioned flight to liquidity and a desire to maintain higher cash balances entered decision-makers’ thinking in the latter part of the decade.

Differences among Nonprofit Organizations
We have discussed the difference in returns by nonprofit organizations of various sizes and the correlation of size to investment return. Returns also vary by type of organization—but with a much less well-defined pattern. As mentioned above, educational endowments are divided by type into public and private, and operating charities can be segmented into cultural, religious, and social service organizations.

If there is an overall pattern that has remained in place through time, it is the tendency for private colleges and universities to moderately outperform their public counterparts. In FY 2013 NCSE, for example, among the 835 participating institutions, private institutions reported an average return of 11.9 percent versus 11.3 percent for public endowments when combined with their supporting foundations. Over time, however, the difference has been slight—in the range of 30 basis points annually over a trailing 10-year time period. The modest private institution performance edge may be attributed to the fact that these institutions have been managing endowments longer than public institutions, which historically have depended on state support and not endowment draws, and a somewhat greater bias toward equities, both traditional and alternative.

Among operating charities, religious institutions have a different asset allocation pattern than cultural and social service organizations because they are more likely to ban certain investments based on moral or ethical beliefs. They also are more likely to apply environmental, social, and governmental (ESG) criteria to portfolio holdings than other operating charities. In the most recent study, for example, 25 percent of study participants using ESG principles apply them to social criteria, led by 63 percent of religious organizations versus 4 percent of cultural organizations and 11 percent of social service organizations.

Conclusion
The thinking that guides today’s asset allocation practices and policies among nonprofit institutions emerged nearly 50 years ago and evolved gradually through time. Much of the change was driven by the nonprofit sector itself, and practices adopted in the sector, chiefly among educational institutions, have been adopted by other investors, both institutions and individuals.

Over the past decade, three trends have shaped asset allocation among nonprofits: a steady increase in allocations to alternative strategies to the point where it is the largest single allocation (and, in reality, no longer “alternative”); decreases in allocations to traditional domestic equities and fixed income; and the relative stability of allocations to international equities.

Even though nonprofit institutions have suffered through two sharp market contractions during the past decade, the endowment model remains the model of choice to sustain spending, maintain purchasing power, and manage risk in all but the most extraordinary markets.

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