The Monitor asked the following individuals who are associated with prominent endowments and foundations to provide their thoughts on what’s “hot” in the endowments and foundations world, what they see as an investment adviser’s role in this world, and other related topics.

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John S. Griswold, Jr., AIF®, is executive director of Commonfund Institute, the educational arm of Commonfund, which manages endowments of higher-education institutions and other nonprofit organizations. Commonfund Institute is dedicated to the advancement of investment knowledge and the promotion of best practices in financial management among educational institutions, foundations, and healthcare organizations.

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Monitor: Please give us your thoughts about what currently is “hot” in the foundations and endowments world.

Larry Siegel: Although a few endowments and foundations have always been interested in alternatives (the Ford Foundation invested in private equity as early as the 1970s), the big push into alternative investments, and especially “liquid” alternatives such as hedge funds, began during the bear market of 2000–2002. Foreseeing poor returns on traditional stocks and bonds, endowed institutions poured money into long-short strategies and other exotic instruments.

During a bear market, alternative investments always “work”; this is why they are called alternatives. However, bond prices boomed during this most recent bear market, in many cases beating the endowments’ alternative allocations. Given 6-percent+ bond yields and 4-percent+ TIPS yields at the start of the bear market, all that the funds really needed to do was to shift a substantial fraction of their assets from equities to bonds and they would have preserved most of their capital or even made money.

This is not to say that hedge funds are useless; far from it. The very best performers have earned returns that simply are not matched by any traditional strategy. Unfortunately, it is difficult to get into these funds, with many having closed because they have reached capacity. In addition, it is difficult to discern which hedge funds are true long-term outperformers and which are just lucky, having prospered in one specific market environment. Hedge fund fees also are a concern; performance has to be really exceptional to justify the high fees charged.

During a bull market, and we seem to be in one, it’s less clear that alternatives are a winner. For the 12 months ended October 31, 2006,
The trend of the past few years has been toward the greater use of alternatives. The trend stems in part from the desire to diversify portfolios, similar to Harvard, Yale, Stanford, and some of the leading endowments and large foundations. It’s a little less marked in the foundation market because of the influence of some large foundations that either have particular missions, investment restrictions, or a large allocation of donor stock, which prevents diversification in some cases. The large, private university endowments provide the clearest evidence of the move toward diversification and particularly into alternative strategies.

Smaller nonprofits are having some difficulty trying to do it the way the big guys do, because it’s clear that to get good returns you must have access to the top managers. It’s very difficult to get into the top managers, particularly in areas like venture capital, certain hedge funds, timber, and others because very often these funds are closed or have very high minimums. We’re looking at the need to find sources of alpha and to find less-correlated strategies. The difficulty is a practical one of being able to access and invest in those areas that look attractive from a return and diversification standpoint.

We’ve also seen a continuing search for more alternative strategies. According to our research at the Commonfund, some of the medium-sized and larger endowments and foundations are going into things like commodities, emerging market debt, distressed debt, strategies that they probably would not have invested in 5–10 years ago.

John Griswold: The whole area of portable alpha is a complex question. Portable alpha is not new, and it’s still not clear, at least in the endowment and foundation realm, exactly what people are referring to when they refer to portable alpha. Clearly the job of most investment professionals is to find alpha and invest in it. But in the endowment and foundation arena the word portable does not apply very often in the same sense that it might in the pension arena. While the concept has been around for quite a while, it may be taking on a new meaning driven by more than a little bit of hype.

One other hot topic is the question of governance. A lot of people are wondering how investment committees can operate effectively without a highly skilled staff (an endowment or foundation of a quarter billion dollars and up). A good deal of discussion is going on about the management structure of these funds, whether they should hire a chief investment officer (CIO) and some analysts, whether they should outsource to a combination of consultants and multi-strategy money managers, or whether they should have a much more active investment committee. Another option is the idea of investment management companies as illustrated by Harvard, Texas, Duke, or Stanford, which doesn’t seem to have become popular.

Bill Coaker: Traditional allocations to U.S. stocks and bonds provided great returns in the 1980s and 1990s, but they haven’t worked as well in this decade. From first quarter 2000 to third quarter 2006, the S&P 500 returned just 2.6 percent annualized. To boost returns, the search for less-discovered strategies has been prevalent for most of this decade. In the past seven years private equity, U.S. REITs, emerging market stocks and bonds, international stocks, high yields, commodities, and some hedge funds provided very nice returns, but now they’re well-discovered.

To boost returns in the next time series, enhanced indexing, long-short, portable alpha, currency overlay, and quantitative models that may optimize the risk-return relationship better than traditional indexes and active management strategies are receiving a lot of interest, and interest in private equity, hedge funds, and commodities continues to be strong.

Relaxing the long-only mandate to allow shorting makes sense to me. Approximately 485 stocks in the S&P 500 have a weight of less than 1 percent. Shorting allows a manager with a negative view of a stock to add more value than simply underweighting or not owning a stock that has little weight in the index. Other ideas that are interesting to me include international private equity, international REITs, diversified inflation hedges, global equity managers, country- or region-specific mandates, commodities, and emerging markets.

Monitor: What do you look for in an investment adviser?

Bill Coaker: I place a premium on experience, idea generation, intellectual depth and curiosity, students of the markets, and a passion for investing. I also value organizations whose culture and compensation practices enable them to attract and retain smart and talented people. I want a consultant that dynamically evaluates the landscape of investment opportunities and is proactive in making recommendations related to asset allocation and manager selection. I want a money manager whose investment process makes sense and has the resources to execute the process. I appreciate brilliant people whose ideas or theses make sense as a source of excess future returns. Lastly, I gravitate toward managers with less style purity—those who think outside the box, analyze the landscape of investment opportunities, and make investments based on that analysis.
Sometimes style purity locks in risk when assets are priced too high or fundamentals are poor or deteriorating. From 2000–2002, large-growth and small-growth managers were locked into high-valuation risk, which led to poor returns when investors became price conscious. Style purity also can lock out alpha. If plan sponsors prohibited U.S. managers from investing in international stocks or strictly prohibited international managers from investing in emerging markets, those decisions locked out a lot of alpha the past five years.

**John Griswold:** If I were a client I would look for someone who, from a fiduciary standpoint, is independent or clearly is going to exhibit independence when making recommendations and evaluating a portfolio. Someone who has access to all of the options needed for a particular client. It is becoming a much more complex challenge to stay in touch with all of the different strategies and asset classes and their relevant performance and value to a portfolio’s management group. It’s critical that the person be able to relate to the investment committee, the ultimate fiduciaries who are managing the fund. Those committees can be tough to deal with particularly in the endowment and foundation arena, where they tend to be multifaceted with a lot of different personalities and opinions. The committee can be large, probably too large in many cases. It’s the investment adviser’s job to try to bring organization and discipline to the process of selecting the investments and helping to manage them. Providing enough information and perhaps a new governance model itself would be called for in many cases. The investment adviser has to be relatively strong and respected by the committee and staff.

**Monitor:** What is the role of an investment management consultant?

**John Griswold:** To guide the committee and staff and provide information, reporting, performance attribution, and probably some observations about the regulatory and legal climate. Changes are in the offing with the potential adoption of the Uniform Prudent Management of Institutional Funds Act, the new uniform act that is going to be much more all-encompassing and will cover all nonprofits. Previously you had the Uniform Management of Institutional Funds Act, the old law, and the Uniform Prudent Investor Act (UPIA) for trusts. The addition of the UPIA standard to the new law will make the law broader. We’re working with the uniform commissioners to educate nonprofit managers on that new law.

**Bill Coaker:** Consultants should focus on asset allocation and manager selection, because those are the determinants of risk, return, and alpha. Money managers should evaluate the landscape of investment opportunities, and if policy prohibits them from optimizing the risk-return dynamic, I want them to suggest we consider changing the policy.

**Monitor:** What do you think is the ideal structure for investment management, something similar to the Harvard model or another model?

**Larry Siegel:** For most smaller to mid-sized endowments, with limited staffs and with trustees who have responsibilities outside the investment profession, use K-I-S-S, (Keep It Simple— I’ll leave out the last word). These smaller institutions do not have the expertise to run a Harvard-like program. The Harvard model involves a very large and very highly experienced and compensated internal staff, in addition to a wide assortment of outside managers. Such a design cannot be replicated except in the very largest institutions.

**Bill Coaker:** Harvard, Yale, Notre Dame, Stanford, and other institutions have a high allocation to alternative assets. Asset classes that often comprise alternatives include private equity (buyout, venture, and special situations), real estate, commodities, and hedge funds. Extra emphasis on alternatives makes sense because there are many assets under that umbrella that are less-efficiently priced, enabling managers to add a lot of value.

I think most U.S. investors have too much of a home-country bias and too much of an emphasis on traditional assets that holds down returns and increases volatility. The correlations of all U.S. equity styles to each other are high, averaging nearly 0.90 and none less than 0.70. A better use of an investor’s risk budget is to emphasize lower-correlated assets that still meet return objectives. To optimize the risk-return relationship, international stocks, emerging markets, private equity, hedge funds, real estate, commodities, and global bonds should be utilized more than they are.

Most public pension plans, mutual fund investors, and 401(k) investors have traditional asset allocations. Institutions with extra emphasis on alternatives are more likely to earn excess returns and reduce risk because they have a larger menu of low-correlated and less-efficient asset classes to choose from.

**John Griswold:** Unless you’re very large, $1 billion or more, the idea of a management company probably should be put aside in favor of a more traditional investment office that is staffed with a CIO or someone with a deep, long investment experience if possible. That can be difficult because investment pros can get paid a lot of money and non-profits don’t tend to be able or willing to pay a great deal. Compensation is a key challenge. However, there are a lot of good people working in this area. There are lifestyle benefits, which can be attractive or can be a point of leverage for institutions. There’s a certain amount of prestige. But clearly a staff size commensurate with the size of the endowment or
foundation is required. Actually the numbers have declined on average according to our research in terms of staffing the investment function. Volunteer committees in this regard can be quite strong, but they also cannot be relied upon simply because they do not have the time to manage a complex portfolio, particularly one with less than fully transparent strategies, which is common now in hedge funds and private capital. There is no ideal model, but improving the traditional model probably is more productive than any other.

One growing part of the business that we observe is a complete outsourcing of the investment office, all the way from policy development to reporting to the committee. That has a couple of advantages because it allows the committee to operate and focus on the policy level so they’re using their precious time (20–25 hours a year) to develop the investment policy and monitor asset allocation, spending policy, conflicts of interest, that sort of thing. They’re not looking for or interviewing managers or even discussing a great deal at the strategy level other than as part of an asset allocation discussion.

Monitor: What are your thoughts regarding conflicts of interest among managers, trustees, and board members?

John Griswold:  This is a key concern. Ideally no one operating as a staff person or a volunteer does any direct personal business with the institution. That’s a strong position to adopt, but in the current environment business relationships are much more transparent and scrutinized by all kinds of people. In certain cases there have been scandals, but those have revolved mostly around compensation rather than conflicts of interest. Conflict of interest is a serious issue in an era of heightened fiduciary responsibility; people are held to a higher standard of fiduciary care, and you need a conflict of interest policy in place. There’s a growing connection between advice and management, consultants are becoming money managers, money managers are becoming consultants, it’s blurring the lines. Also, it’s difficult for trustees to deal with that because they have to ask very tough questions and perhaps do some extra due diligence. That may be a product of how good the money manager business is, on the one hand, and perhaps how tough the consulting side of the business is on the other. To work on a fee-only basis is tough these days. Nevertheless, there’s an overriding concern that there could be regulatory oversight from one or more bodies, particularly if there’s any problem.

Bill Coaker:  It seems like a lot of managers think that building relationships will gain new business. Plan sponsors need to make sure they make investment decisions in the sole interest of plan beneficiaries and not based on who they like.

Larry Siegel: We all know about the flow of assets into hedge funds, so I’ll focus on other, more recent trends. We have seen a lot of interest in portable alpha strategies, typically designed as a package by one manager who acts as both alpha source and beta provider. These strategies make economic sense (all alpha is, in principle, portable) but raise concerns about leverage risk, monitoring, and reporting.

We have also seen a lot of interest in energy and infrastructure funds, especially outside the United States; and in structured product on the fixed income side. Finally, hedge funds and private equity have invaded each others’ territories, with PIPE (private investment in public equity) and many other exotic strategies proliferating.

Bill Coaker: I see trends toward private equity, hedge funds, enhanced indexing, portable alpha, commodities, measured tactical asset allocation, currency overlay, relaxing the long-only mandate, and greater interest in lower-correlated assets to better optimize the risk-return relationship.

Institutions are evaluating whether enhanced indexing using either quantitative and/or fundamental factors is superior to indexing based on market capitalization. Highly successful hedge fund managers such as Renaissance, D.E. Shaw, and AQR have developed enhanced index and/or long-short strategies using sophisticated quantitative models. Renaissance’s 175/75 long-short product and Rob Arnott’s Fundamental Index (RAFI) have received a lot of investor interest. Indexing based on market cap does not make sense to me because, if it worked, a few companies would have grown much larger than they actually have. Enhanced indexing based on equal weighting, fundamental factors, or quantitative-predictive signals makes more sense to me than market cap-based indexing.

Investor interest in commodities has strengthened substantially. China and India have vast supplies of labor but limited natural resources. Never before has as large a percentage of the world’s population been on a fast track toward middle-class development. If an effective investment strategy going forward is to overweight what China and India will buy, and underweight what they will sell, extra exposure to commodities may prove helpful. That said, for the first time in two decades energy companies are investing heavily in exploration, and if vast new supplies emerge, energy prices would stabilize or fall. In short, I generally subscribe to the demand-driven case for a secular bull market in commodities, but their most important
benefit is that, more than any other asset class, commodities have the lowest correlation to all other assets, so their diversification benefits are very high.

Interest in inflation hedges has picked up. A major debate among investment professionals is the rate of future inflation. As I just noted, with rapid growth in China, India, and other emerging markets, never before has as large a percentage of the world’s population been on a fast-track toward the middle class, which could signal future inflationary pressures. On the other hand, the global supply of labor provided by those countries could keep inflation relatively tame. Five years ago, to ward off destructive deflationary signs, Federal Reserve Banks around the world pumped record levels of liquidity into the global monetary system. They successfully warded off deflation, but the result has been a massive increase in debt, which will make it difficult for them to raise interest rates to combat inflation, should it occur, without causing a lot of bad debt.

Other trends include international private equity, diversified inflation hedges, international REITs, and some investors are cautiously adding to their venture capital allocations. Lastly, I expect the high use of leverage by consumers and businesses in recent years will lead to high relative returns for private equity strategies that emphasize distressed debt and distressed equity.

**John Griswold:** We’re beginning to see more types of alternative strategies. People have become conditioned to lower return and in fact that hasn’t come true. We saw a 10.6-percent average return this past year in our educational study (the 12 months ending June 30, 2006), which is a pretty healthy return. People have been looking more widely to find alpha. There’s a lot of specific interest in areas like timber, distressed debt, emerging markets—still some great opportunities globally. It’s difficult to assess the quality of the returns that might come from private equity because the funds are so large and when they get that large, in our experience, the returns tend to be arbitrated away—particularly given the very high acquisition prices that are being paid for some of these companies. Clearly a lot of that is going to shake out in the next three to four years, so it’s possible there could be some good returns simply because the companies themselves that these big syndicates are acquiring may have assets that can be unlocked in a changed management structure.

Hedge fund strategies are so broad that they almost defy description. But it’s tougher to make the mid- to high-teens returns that people were expecting five to 10 years ago. Hedge fund managers are struggling to look for new strategies and I think probably quite a few will find them. The question is whether the ordinary manager of an endowment or foundation will find that manager before he closes. Investment advisers or consultants can be helpful because they may have the resources and the networks to find those people before they close. If the compensation structure of hedge funds stays the same, they should continue to attract some very bright people who can produce very good returns relative to the average stock picker. Again, the challenge is identifying those people. Another problem is the reporting isn’t adequate in that arena.

**Monitor:** What are some of the challenges in implementing these strategies into portfolios, use of specific types of investment vehicles, etc?

**Larry Siegel:** The biggest challenge is the staff capacity needed to perform the due diligence and risk monitoring required by these new strategies. The risks of traditional long-only investments are very well modeled by alpha and beta, or by a multibeta model such as the Fama-French style model. With these new types of investments, counterparty risk, leverage risk, liquidity risk, “blowup” risk, and fraud risk come into play. All but the largest endowments and foundations have only one, two, or three people—and sometimes part of one person—dedicated to investment management, so they are in a poor position to evaluate all these risks.

The other critical issue with these newer strategies is the overall level of fees. If you transfer 2 percent of capital annually from the asset owner to the manager, with no investment return and thus no performance fee, after 50 years your capital will be all gone. Of course this is an extreme example (you would fire the manager long before 50 years), but it gives an indication of how fat the fee structure really is. Performance has to be truly extraordinary before fees to deliver an acceptable return, averaged across many alternative products and funds, after fees. Only endowments and foundations that can identify these exceptional performers will have superior results from alternative investing.

**John Griswold:** The problem is access, knowledge, and information. It’s difficult for a volunteer committee to get this; it’s even difficult for an experienced investment professional to get it. Clearly the use of consultants, advisers, or multimanager structures can help when the resources are large and they’re proven to produce better returns. The challenge is to put a governance structure together that can actually do all that and accomplish due diligence, monitoring, risk management, gaining access, etc., at a reasonable price.

A couple of thoughtful people recently said they thought fees and cost were going to be the next frontier—if not of government regulation then observation by the SEC, NASD, and perhaps other bodies. It’s a matter of concern in part because some of the alternative category managers are so
Bill Coaker: Private equity has seen much larger allocations from plan sponsors, which could push future returns lower. Due to Sarbanes-Oxley and global economic growth, the investment universe for private equity has increased considerably, but perhaps not at a pace equal to cash inflows. However, the buyout funds have grown very large, resulting in greater competition for deals and raising the price of buyouts. Further, buyout firms have heavily leveraged their companies. Leveraged buyout returned on average about 18 percent the past two decades, but higher purchase prices and heavy debt could push future buyout returns lower. I would not be surprised if the median buyout fund underperforms the S&P 500 over the next 10 years, so plan sponsors thinking of joining the festivities now should not hire buyout managers—or venture capital managers—simply to fill an asset allocation bucket. That said, I think prudent selection of high-quality private equity managers still can add considerable value.

Short capacity could become an issue if long-short investing becomes widely used. It’s also possible the alpha in long-short could be reduced or eliminated if large sums of money swamp the short market.

There have been legal and tax developments favorable to the REIT structure in numerous countries, and the process has begun in other countries. If the legal process stalls, international REITs will remain a small market with limited opportunity, but there will be a lot of opportunity if the U.S. REIT structure is adopted internationally.

Monitor: In managing an endowment, to what extent do you feel you need to “do good” in structuring your portfolio through investments?

John Griswold: We have not offered social investment trends since the close of South Africa-free funds in the mid-90s for two reasons. On the one hand, we feel a good deal of the concern about social investing is misplaced in the sense that the organizations that do it very often are spending a great deal of time worrying about screens for their investments and they may lose sight of their own mission. A nonprofit should focus on its own mission, not everyone else’s. The problem is there are so many different screens out there that when we’ve tried to help our clients open a fund, there’s no agreement on the screens to be applied. Now, of course, it’s not just tobacco, oil, firearms, nuclear; now it’s corporate responsibility, environmental concerns, etc. It’s a very splintered series of issues and concerns that has to be dealt with, which from a practical standpoint makes it difficult to come up with a design for an investment or investment fund that covers all those areas and can promise adequate returns. On the other hand, from a fiduciary standpoint, the job of an investment committee and staff is to make the most money they can and to build the resources of the organization so that it can achieve its own mission. Clearly the focus should stay on that goal.

Monitor: Is your foundation set up under a donor-advised fund structure? Would you ever consider having a third party provide the community foundation a private-labeled donor-advised fund?

John Griswold: Donor-advised fund structures have been growing rather rapidly over the years, but they’ve come up under regulatory scrutiny all the way from the Senate Finance Committee down to the local attorneys general because there has been a fair amount of abuse in donor-advised funds. People giving company shares and yet still running the company, having a real say in how the money is used, spent, and even advised is an area for caution in the fiduciary area. The donor-advised funds are popular. The big, huge commercial ones—Fidelity, Vanguard, Schwab, etc., just flourish and I think that’s an expression of the fact that people want to be able to control the donations they make more than they used to. They’re not willing to trust the individual organization with all of the choice of how to use the money as much as people used to do. That’s the old-style philanthropy. We saw venture philanthropy emerge 10 years ago, but it’s still around. People want to get on boards and direct how the donor money is used. Again, organizations have to be terribly careful as to how that happens. Clearly there ought to be a good deal of legal consultation on the structure of the gift and how the gift is put to work. Donor agreements have to be drafted carefully or revised in many cases because it’s still the donor’s wishes and intent that legally guide how the organization must use those funds.

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