

THE COMMODITIZATION OF ENDOWMENT & FOUNDATION INVESTMENT RETURNS

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For years, consultants and advisors have pitched their services to endowments and foundations based on their ability to pick the best securities and/or the best money managers. Investment committees love to think that they have found something or someone special that will make them look better than their counterparts and propel their organization to new levels. Consultants have fed that desire with stories of beating the markets and hitting investment home runs.

The truth is harder to swallow. For most, the truth lies in boring portfolios, the search for non-correlating asset classes, solid Investment Policy Statements and a staunch, steadfast belief in Modern Portfolio Theory.

A CHANGE IS GONNA COME

The Prudent Man Theory

The standard to follow used to be the Prudent Man Theory. The essence of the Prudent Man Theory was that if you acted as any prudent man would act then you passed the fiduciary test. The rule changed in 1990 to The Prudent Investor Rule. The Prudent Investor Rule says that a fiduciary has to act as a prudent person "familiar with such acts" would act. That standard is totally different and a much tougher one. Fiduciaries are judged based on what a prudent expert in their field would do. It is no longer acceptable to use your judgement to make decisions as a fiduciary. Your judgement has to have a foundation of expertise in investing or it won't pass muster. If you don't have that expertise internally, then you must hire that expertise so that your judgement is informed and will comply.

It is important to remember that it is possible to be intelligent and ignorant at the same time. Ignorance is a lack of knowledge in a certain area, not a lack of intelligence. Ignorance coupled with an intelligent mind was acceptable in the Prudent Man Theory, but that is no longer the case.

Total Return vs. Income Only

For years endowments and foundations adhered to the income only rule of only paying out what they could earn in dividend and interest payments. That is why so many endowments and foundations invested solely or mostly in bonds. Risk was defined in ratings by Standard & Poor's and Moody's (the two most prolific bond rating agencies) and investment grade bonds with a high interest rate were the endowment version of a home run.

Once again, research overwhelmingly showed that a diversified portfolio of bonds, stocks, and other investments was not only less volatile in the long run, but produced higher returns over time. This idea of diversification was tagged as Modern Portfolio Theory (MPT) in 1953 and is the gold standard for fiduciary management across the country. The Uniform Prudent Management of Institutional Funds Act (UPMIFA) has become the code used by States all over the country to determine fiduciary prudence and the guiding principles of UPMIFA are founded on Modern Portfolio Theory. With the adoption of UPMIFA, most States have changed from an income only rule to a total return rule for oversight of endowments and foundations.



Assumptions

With the shift from the Prudent Man Rule to the Prudent Investor (or Prudent Expert Rule as it is referred to by the Department of Labor) and from income only to total return investing as the foundation for governing investor prudence through UPMIFA, we can make some conclusions about how endowment and foundation money should be managed. If you would conclude that the Prudent Investor would use Modern Portfolio Theory to implement a prudent investment strategy, then you must conclude that an investment committee charged with acting under the Prudent Investor Rule would need to do the same thing.

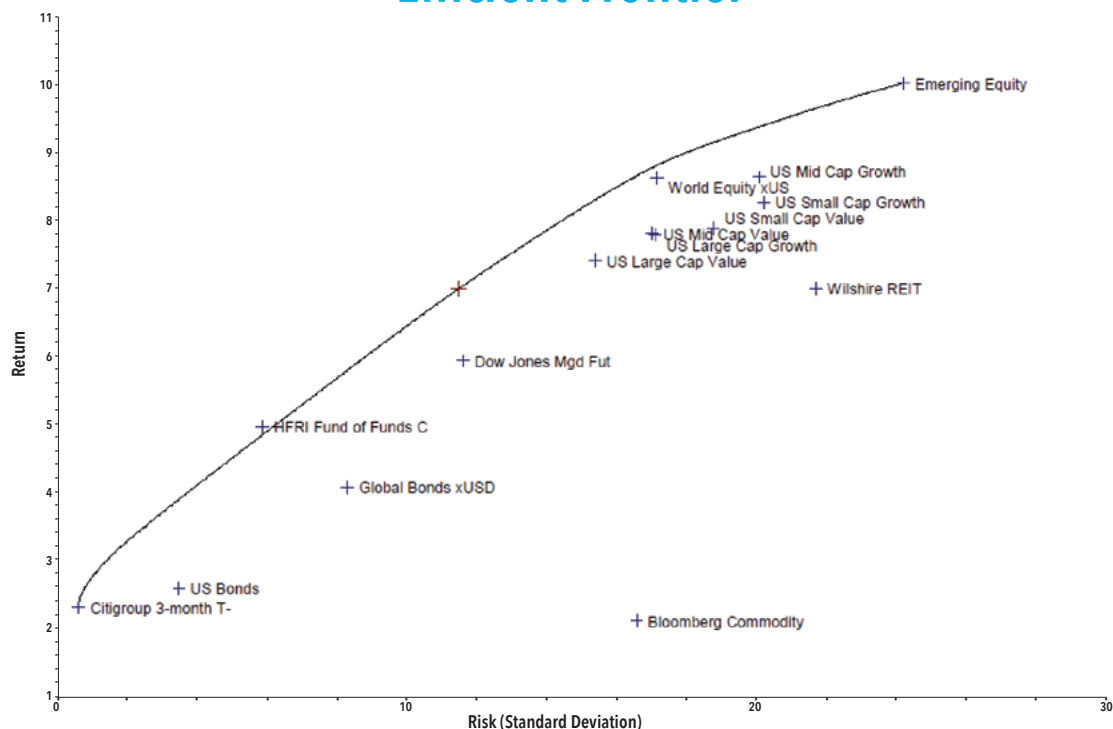
Modern Portfolio Theory uses some basic guidelines to construct portfolios:

- Each asset class has a projected risk/return scenario.
- Diversification of asset classes will reduce volatility and, therefore, risk.
- Reducing risk through diversification does not necessarily reduce projected return.
- Using capital market projections for risk and return per asset class allows for the creation of an Efficient Frontier of possible portfolios.

Use of Efficient Frontier Portfolios allows an investor to maximize the amount of projected return in a portfolio where they can identify an appropriate amount of risk. Or they can minimize the amount of projected risk in a portfolio that is created to produce a certain amount of return.

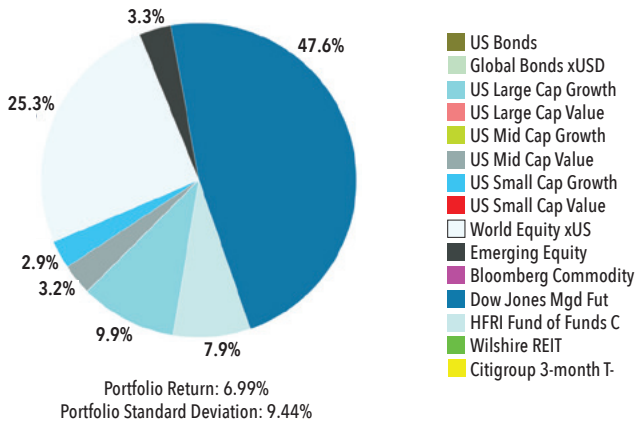
The following pages were prepared using Zephyr. The Zephyr software used to prepare this presentation relies upon certain indexes and databases and has made use of certain assumptions in creating the proposed benchmarks and investment portfolios. Although these underlying indexes and databases are intended to be as accurate as possible, there is no guarantee that these databases and indexes, or the underlying data, are accurate or up to date.

Efficient Frontier

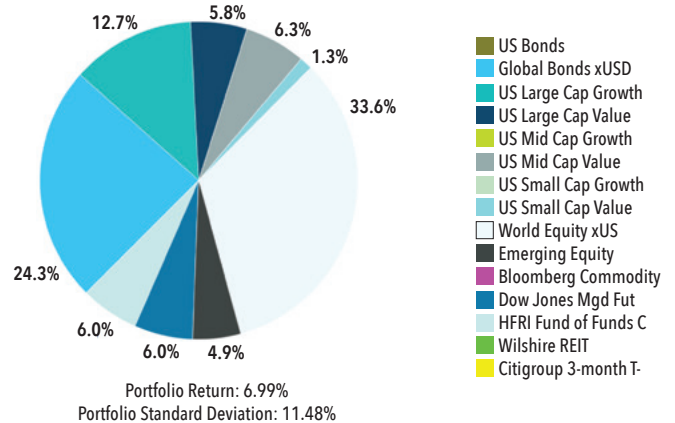




Asset Allocations Active Portfolio Unconstrained



Asset Allocations Active Portfolio Constrained



Two Important Factors

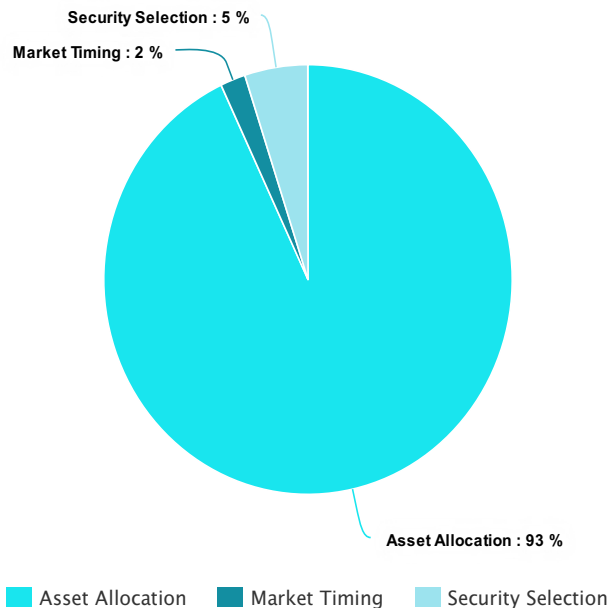
Using MPT to create appropriate portfolios does not, in and of itself, lead one to the conclusion that endowment and foundation portfolio returns have been commoditized. You have to take into consideration other elements before you can make that conclusion. There are two significant pieces of research that will help defend that premise.

Brinson, Singer, and Beebower Study

The Brinson, Singer, and Beebower Study came out in 1991. It was the follow-up on another study done in 1986 by Brinson, Hood, and Beebower. The study took 111 of the largest pension funds in the country and conducted forensic research on the individual accounts to see if they could make some conclusions on what aspect of investing has the most impact on investment returns over time. What they found was astonishing. Even though industry professionals and individual investors seem preoccupied with finding the best investment and determining when is the best time to invest, the study found that those two activities just weren't that important. In the study, security selection accounted for just 5% of the overall return of the portfolio over time. And market timing was even worse, only accounting for 2%. Asset allocation was far and away the winner. Asset allocation (determining which asset classes are appropriate and how much you will use of each asset class to create a portfolio), in the Brinson, Singer, and Beebower Study, accounted for 93% of performance over time. That result should have been a game changer for investment committees across the country, yet still we find committees spending the majority of their time looking for the next great manager that will make a big difference in their portfolio.



Determinants of Portfolio Performance II An Update By G. Brinson, B. Singer, and G. Beebower



Source: Financial Analysts Journal, May-June 1991. "Determinants of Portfolio Performance II. An Update," by G. Brinson, B. Singer, and G. Beebower.

Eugene Fama

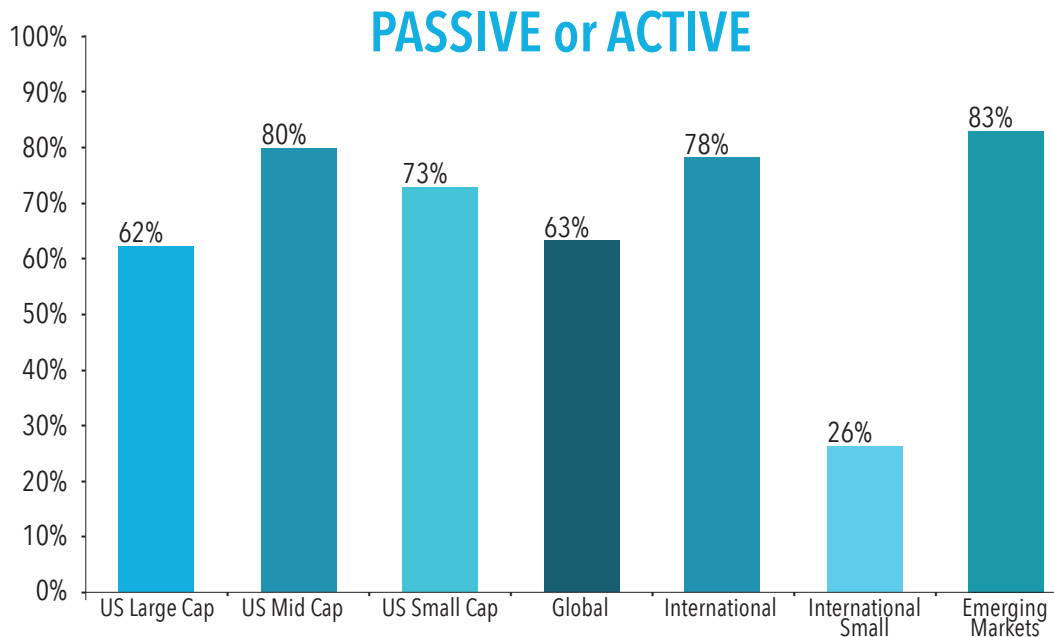
Next is where Eugene Fama's research comes in. It is completely understandable that a group of smart people should be able to pick better than average¹ money managers for their portfolios. Especially with so many active managers espousing their ability to do just that. But believing that something is right simply because it makes sense and sounds good is not enough. You must go deeper and look at the evidence. That is why it is so nice to have top level economics professors, like Eugene Fama, research issues, such as active vs. passive management, and give us empirical evidence to guide our decisions. The great thing about evidence is that it doesn't take sides and it is not swayed by a good story. It is what it is.

Fama's research, for which he won a Nobel Prize, is extensive, but the short version of what Fama said was:

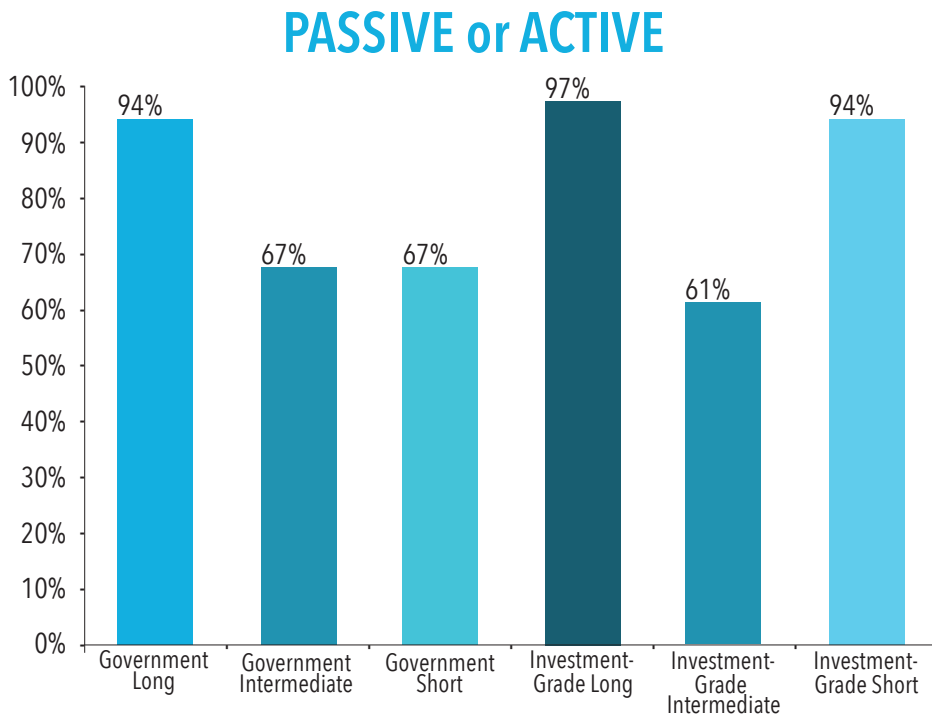
- There are active managers that can beat their index consistently over time.
- It is a very small percentage, about 2%.
- Even those managers will underperform their index for extended periods.
- It is very difficult to tell the difference between a consistently good and a lucky manager.
- It takes about 37 years of investing to know for sure.
- Every year, the majority of active managers, underperform their index.

So, based on Fama's research, it seems that the easiest way to hold an above average manager is to buy an index equivalent and pay much less in fees than their active counterparts. The low fees should thrust most investments into the top half of their peers for the year.

¹ Fama, Eugene F. and Kenneth R. French. 2010. "Luck vs. Skill in the Cross-Section of Mutual Fund Returns." The Journal of Finance, 65(5), 1915-1947



Percentage of Active Public Equity Funds That Failed to Beat the Index Five Years as of December 2011. Source: Standard & Poor's indices versus active funds scorecard, year-end 2011. Index used for comparison: US Large Cap-S&P 500 Index; US Mid Cap-S&P MidCap 400 Index; US Small Cap-S&P SmallCap 600 Index; Global Funds-S&P Global 1200 Index; International - S&P 700 Index; International Small-S&P World ex. US Small Cap Index; Emerging Markets- S&P IFCIC Composite. Data for the SPIVA study is from the CRSP Survivor-Bias-Free US Mutual Fund Database.



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More Assumptions

In order to follow this thought process to its conclusion we have to make a few assumptions:

1. Investment committees are not willing to take on increased liability by straying from the path defined by the governing bodies that have authoritative oversight. (Use of Modern Portfolio Theory.)
2. Investment committees are able to determine their individual equilibrium spending rate and identify an appropriate desired return for their organization.
3. There is some consistency in the development of capital market projections and some well-known benchmarks for comparison. (Black Litterman, etc.)
4. Investment committees will identify which asset classes they are willing to use and which asset classes they are not willing to use.
5. There is a basic desire for investment committees to create portfolios that maximize return while minimizing risk.

Logic 101

If you can agree with the assumptions listed above then you can go back to your Freshman Philosophy 101 class and draw some pretty interesting conclusions. Once an investment committee has determined their projected return and decided on their appropriate asset classes, they can find their portfolio on the efficient frontier...**and so can everyone else**. That means that theoretically everyone's portfolio should look virtually the same. So the portfolio becomes a commodity. Now the only thing left to consider is price. With a commodity, price becomes a critical component to success. How inexpensively can you access that allocation model? The cheaper you get the portfolio the more money you make. That's pretty simple. So what else is there?

Advisor Alpha

Advisor alpha is that thing that makes an advisor worth the extra money they are paid given the fact that almost anyone can create a pretty good portfolio without an advisor. Here are some things to look for when trying to determine advisor alpha.

- How does your portfolio vary from the efficient frontier and why? Some consultants and advisors try to look good by putting managers in the portfolio that have a projected risk/return higher than the comfort level of the investment committee. Staying inside your comfort zone is a critical component of investment success. Inside your comfort zone you make decisions with your pre-frontal cortex, the cognitive part of your brain. Outside your comfort zone you tend to make decisions with your amygdala or your emotional side. The emotional side doesn't normally make good investment decisions. If you get outside of the investment committee's comfort level the portfolio won't actually get the returns that are forecasted because that lack of comfort forces bad decisions along the way. If this concept interests you, research "behavioral investing".
- With the previous point in mind it's not just risk/reward that determines an investment committee's comfort level. The efficient frontier portfolio created without any concern for how the investment committee feels about the underlying asset classes can look pretty weird. For instance, not many investment committees would be comfortable with 40% of the portfolio invested in managed futures or 60% in illiquid real estate. Every investment committee has certain biases for and



against certain investments. Some like bonds, some hate bonds. Some like commodities and some just won't have them. Forcing an investment committee to invest in areas that make them uncomfortable forces them out of their comfort zone and into bad decisions. It's important to create a portfolio that is as close to the efficient frontier as you can get and still have a portfolio that the investment committee can embrace. That's how you maximize portfolio potential. *Refer back to page 3 to see the difference between an unconstrained and constrained portfolio on the Efficient Frontier.*

- Portfolio turnover or, should I say, lack of portfolio turnover is a factor. Investing institutional money is, for the most part, boring. Or at least it should be. Those advisors that are trying to impress the committee tend to hire and fire money managers more often than those that are investing for the long-term. Good advisors spend a great deal of time and energy on due diligence so they can proactively decide to do...well...nothing. Chasing returns has proved to be exciting and not very productive far too often to be considered a valid strategy for most investment committees.
- Fiduciary governance is the rock upon which successful foundations build. A robust fiduciary platform will create an investment process that is **definable, defensible, and repeatable**. It will be a process that is not dependent on one or two people and could be implemented by an entirely new investment committee if need be, without a hitch. Those advisors that are willing to commit to managing a committee's fiduciary governance will help the committee form an investment process that is set up to make good decisions and good decisions over time create good results. Helping a foundation form a robust and fiduciarily responsible investment process is much different than simply providing information to the committee upon request or offering up an Investment Policy Statement that was designed to protect the investment professional and his/her firm instead of the endowment/foundation. It means that the advisor is willing to create an investment process that is designed to protect and promote the agenda of the institution and will put the interests of the institution above the interests of the advisor.

So, what does all of this mean? It means that the part of the investing world that so many people focus on has been, for the most part, commoditized. The part of the investment process that seems more boring and less exciting is where the focus should be. Portfolio construction, a robust due diligence process, fiduciary governance, and behavioral finance are the keys to long-term success. The chance that your committee will develop this kind of process tends to increase if you can get your advisor/consultant to sign on as a fiduciary to the investment process. If you can get that done and decrease the importance of manager selection and oversized returns in favor of focusing the investment committee's attention on creating a solid, robust investment process, then you will be well on your way to the top of the class for endowment and foundation investing.