Performance Management:

How do (some) perpetual portfolios outperform?

Tanya Lee, CIM and Pauline Yan, CFA
Associate Portfolio Managers
1832 Asset Management

This article provides an overview of what charities and endowments are doing with their investment portfolios. Specifically, we look at performance and how the larger or "elite" institutions are outperforming their smaller counterparts. We will highlight the empirical evidence that outperformance is directly related to the investment policy. In addition, we look at the importance of asset allocation and whether strategic allocations to alternative investments might also explain variations in performance.

Working in the world of institutional asset management for over 10 years has afforded me the opportunity to meet with many clients and know that they often come in very different shapes, colors and sizes. However, no matter how big or how small one of the first questions I always ask a new client is if they have an investment policy statement. Invariably within the charitable space the answer is typically "yes". But sadly the IPS is often a little (sometimes a lot) outdated, hasn't been reviewed in a number of years and no longer accurately reflects the goals and objectives of the board.

When we begin the process of reviewing their investment policy statement (IPS) and looking at asset allocation, asset classes and investment constraints, the question that is always posed from potential and existing clients is "what are other charities doing"? Over the years I have attempted to answer this question only to find there is limited information and limited resources available on this subject. There is no centralized governing body to oversee investment practices of all charities and endowments and to disseminate its findings to the benefit of all.

This article provides an overview of what other charities and endowments are doing with their investment portfolios. Specifically, we look at performance and how the larger or "elite" institutions are outperforming their smaller counterparts. We will highlight further into the article, the empirical evidence that outperformance is directly related to the investment policy.

In addition, we look at the importance of asset allocation and whether strategic allocations to alternative investments might also explain variations in performance. While this article is not intended to be viewed as standard operating procedures for how endowments should structure their investment portfolios, we hope that it can provide some direction in which to frame investment discussions with the Board and with your investment manager.

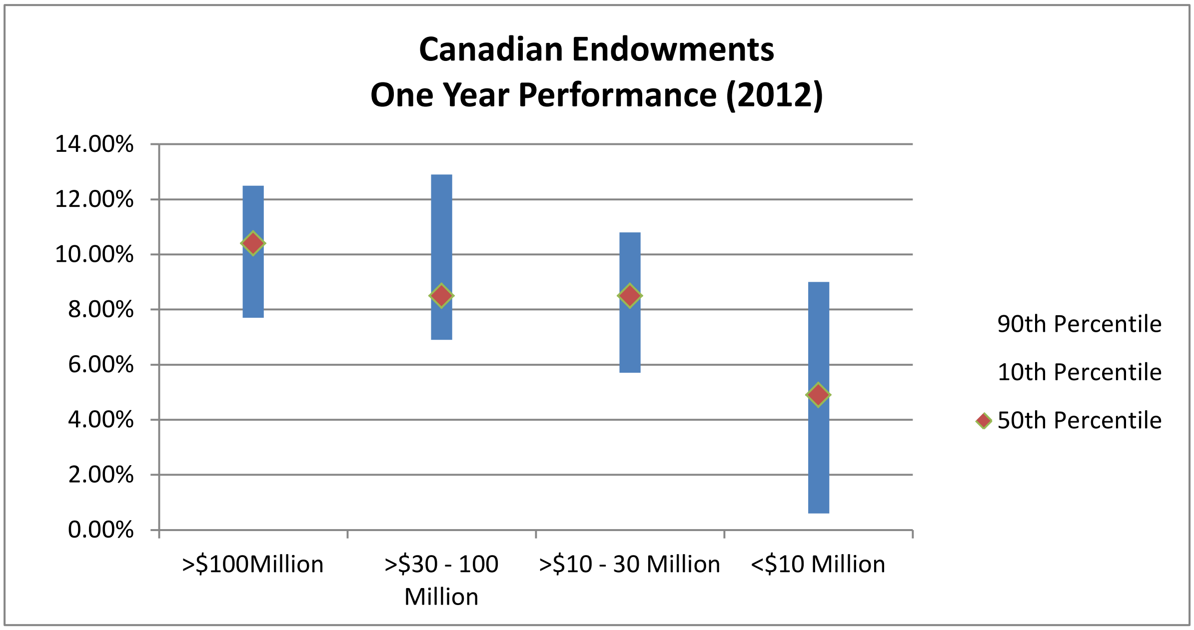
Performance

Investment portfolios for charities and endowment funds are often critical to the finances of the institution and performance of these funds may materially impact the spending policy. The majority of respondents to the Canadian Association of University Business Officers Endowment survey indicated a positive relationship between performance of their endowment funds and their spending policy[1]. In another recent survey Imagine Canada's Sector Monitor reports almost 40% of charities claim they may experience difficulty at some point between the next 4 to 16 months in covering expenses[2], further highlighting the important role an investment portfolio can play on the charitable impact of organizations.

Despite its importance, as we mentioned earlier, very little information is available on the performance of other endowments. Since the crisis of 2008, many institutions have questioned their investment portfolio strategy and they may question how they were doing relative to their peers; are they on the right course. We have all heard of the enviable performance of endowments of elite ivy-league universities, but are these rumors valid and how are they achieving superior results?

Below is the one year performance of responding Canadian endowments categorized by assets under management for the calendar year ended December 31, 2012.

Chart 1



(Souce: Canadian Association of University Business Officers, Endowment Survey 2012)

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[1] University Investment Survey, Treasury and Investment Committee, Canadian Association of University Business Officers, May 2013.

[2] Sector Monitor. Lasby, David, Barr, Cathy. Imagine Canada Vol. 3, No. 2, 2013

While not a definitive indicator, it does seem that empirically, the largest institutions in Canada do enjoy superior investment results than their smaller and mid-sized peers. This finding was corroborated in a recent study published in the Financial Analyst Journal which found that amongst endowments in the US, "elite institutions earn superior returns" and these outperformances are persistent.[3]

Another observation this chart highlights is the variance of performance returns for the smaller endowments is greater than all other cohorts. This may be an anomaly for the reporting period; it may illustrate volatility of the underlying asset classes, or it may be a by-product of variances in IPS standards.

Why is an IPS important?

The Investment committee of any foundation or endowment often has a lot on their plate with many issues to discuss at any meeting. The investment portfolio is just one of a number of topics on the meeting agenda. In a recent survey of university endowments in Canada, the largest endowments, ones with over $100 million under management, may employ an average of two full time staff who are tasked with the responsibility of investment management. This is a resource few endowments can allocate and it is common for foundations to hire investment managers to act on their portfolio. An investment committee is then typically established to retain oversight of the portfolio, but delegates the day to day responsibilities of managing the fund to the investment manager. The investment policy statement then becomes more than just a formality; it is explicit instructions on how the funds are to be managed by the investment manager. Hence, it becomes an important tool for foundations to ensure that longer-term goals are met, to establish policies and procedures for investment manager oversight and for risk management. A well-constructed investment policy statement will clearly state the objectives for the portfolio and the risk parameters within which to achieve those goals.

The IPS is like a road map to take the investment portfolio from one point to its destination and just like the road map when one is driving, this map should include specific features. These features include a formally stated investment objective, liquidity requirements, risk tolerance, an asset allocation strategy with investment performance benchmarks and should include a rebalancing strategy. So while many charities and foundations hold a map, it is not clear how many have marked their route. The University Endowment Investment Survey, mentioned previously, found that while most respondents (between 89% - 100%) have stated an investment objective on their IPS, only 77% of endowments with under $10 Mill in AUM have a formal asset allocation strategy. This cohort is also the least likely to have performance benchmarks stated on the IPS (33.3%). On the other hand, endowments with assets greater than $100 million had maps with a formal asset allocation strategy (100%) and were more likely to have formal benchmarks (95.8%). They were also more likely to have a formal rebalancing strategy (79.2%) than endowments with less than $10 million in assets (11.1%). With these statistics, we may be able to infer that larger endowments achieve superior results because they have clearly marked routes with landmarks to gauge their progress.

[3] Do (Some) University Endowments Earn Alpha? Barber, Brad M., Wang, Guojun, Financial Analyst Journal Volume 69, Number 5, September/October 2013

A properly drafted investment policy statement should include (at minimum) the following items:

- Charities or Foundation Characteristics including a background or history, mission statement and/or statement of objectives
- Time horizon for the funds. Are they perpetual in nature?
- Liquidity needs. Are the predictable annual cash flows? Are any of the assets to be used for day-to-day operations?
- Cash Flows. Will the charity or endowment be making regular contributions to the fund? Is there an annual disbursement amount?
- What are the return objectives of the board? Is there a target return? Over what period?
- What is the risk tolerance of the board? What kind and to what degree are they prepared to take?
- Asset allocation targets and ranges, including investment performance benchmarks.
- List of permitted and prohibited investments. Qualitative and quantitative restrictions.

Why Asset Allocation Matters

Not only is the investment policy statement an oversight tool, it plays an integral part of portfolio construction and how the portfolio achieves the long term goals for foundations and endowments. It has been found that the asset allocation outlined in the Investment Policy Statement determined 91.5% in the variation of quarterly returns between investment portfolios over a 10 year period. And because any active asset allocation the investment counselor provides is based on the benchmark weights, it goes to reason that active management is conditional on the integrity of the investment policy. Taken together, investment policy allocation and active asset allocation accounted for 93.3% of the variance in portfolio returns[4].

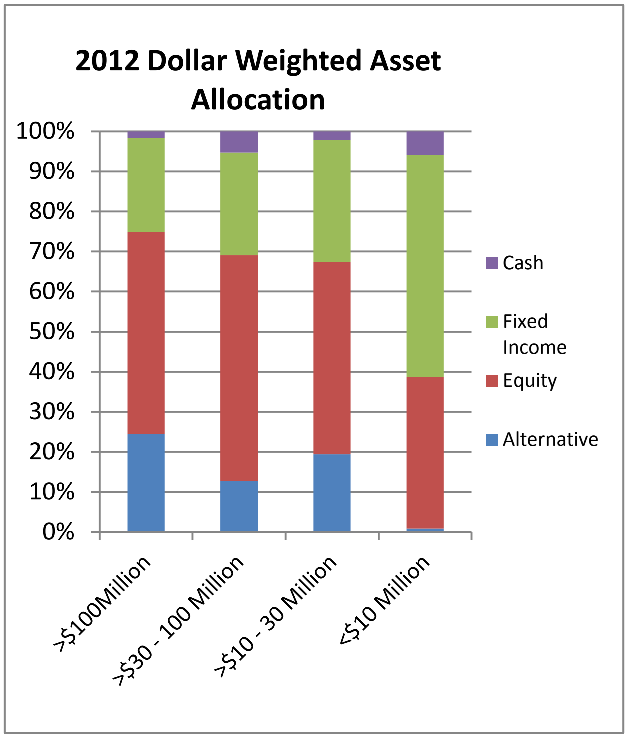
If we hope to achieve the optimal return within the risk parameters of the portfolio, it seems clear that asset allocation is the single largest determinant. While the largest endowments may have access to high profile consultants and investment fund managers, mid-sized and smaller endowments may also be able to enhance their portfolio return through re-examining their investment policy.

Taking a closer look at Canadian institutions, we do see differences in the way organizations deployed investment funds. Looking at the reported asset mix of these endowments, we see the largest institutions investing more in equities and alternative asset classes than their smaller and midsized counterparts. Coincidentally, the larger institutions allocate less to Fixed Income and Cash & Equivalent asset classes. The higher allocation to equity and alternatives show the larger institutions having a higher risk tolerance. This may be because they have

[4] Determinants of Portfolio Performance II: An Update, Brinson, Gary P., Singer, Brian D., Beebower, Gilbert L., Financial Analyst Journal, May/June 1991.

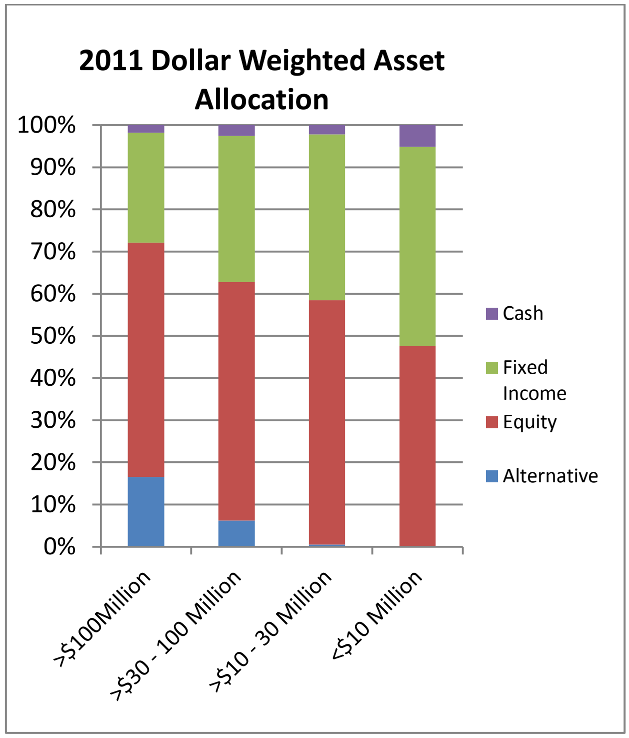
employed full time staff to oversee the investment portfolio as mentioned earlier or it may be a byproduct of these organizations having multiple cashflow streams and therefore less dependent on their investment portfolio to produce income from bonds to subsidize operating or distribution needs. For smaller institutions, the reliance on bonds may be due to their perceived conservative nature, their coupon stream and the attractive historical returns. However, this allocation may prove disadvantageous in a stubbornly low interest rate environment or in a rising interest rate environment.

Chart 2



(Souce: Canadian Association of University Business Officers, Endowment Survey 2012)

Chart 3



(Souce: Canadian Association of University Business Officers, Endowment Survey 2011)

Everyone knows the saying “no pain, no gain”. When applied to the investment realm, it implies that higher returns cannot be achieved unless the investor is willing to take on higher risk and therefore suffering some pain should that security or sector underperform. Many investors have historically viewed alternative assets as one of the riskier asset classes – one that may bring on more “pain” than the traditional bonds or money market securities. From a stand-alone perspective, the investor is right. Alternative investments may experience more volatility of returns – in good years, they may greatly outperform even equities and in bad years, they may have double digit negative returns. Understandably, that is hard for any investor to stomach. However, when we look at their inclusion into the total portfolio as a whole, another picture emerges.

In the study published by the Financial Analyst Journal, the authors found that elite institutions generated superior investment results and they also found that it was almost entirely attributable to the investment portfolio’s relatively large allocations (compared to smaller portfolios) to Alternative investments[5]. While the study did not examine the strategies used in the alternative investment vehicles, they were able to conclude that "alternative investment strategies deliver alpha (i.e., positive risk-adjusted returns)." When taken in the context that alternative investments historically exhibit a lower or even negative correlation to traditional asset classes such as equity or bonds (negatively correlated asset prices move in opposite directions), the value of alternative investment emerges. These factors may also contribute to the trend of increasing alternatives exposure in portfolios year over year as demonstrated by the 2011 and 2012 dollar weight asset allocations depicted in chart 2 and 3. While this article is not implying all alternative investments will generate alpha or superior results, the findings do support a continuing dialogue on the risk and rewards for these investments exhibit and their merit for inclusion in the portfolio.

Call to Action

Performance in an investment portfolio can help or hinder an organization. It can mean the difference between protection of capital or the erosion of capital over time. When we look at the relative returns achieved by the "elite" institutions (chart 1) we see large variances of performance returns in particular for the smaller endowments. As we mentioned this may be an anomaly for the reporting period; it may illustrate volatility of the underlying asset classes, or it may be a by-product of variances in IPS standards. If it is in fact due to variances in IPS standards then the smaller to mid-size institutions should take notice. The single most important factor that contributes to the success of your long term investment portfolio is a strategic plan. A plan, or as referred to earlier, a "map", is required to mark your route to your destination including landmarks to gauge your progress. And like most maps, an IPS needs to be updated regularly. An annual review of the IPS by the investment committee or board with your investment manager will help ensure that it remains an accurate reflection of the charities' investment philosophy and practices.

The second most important factor in determining performance is the strategic asset allocation. Smaller to mid-size institutions can benefit by conducting discussions about their asset mix with their investment manager. Questions to focus on include if the IPS accurately reflects the risk tolerance and return objectives; consideration of the inclusion of alternative investments as an asset class. Having a dialogue on the risk and rewards for these investments and consider their merit for inclusion in the portfolio enhances the oversight process. Institutions can also ensure target asset mix and ranges around each asset class are formalized. In addition benchmarks ensure the institution has a performance measurement tool and helps provide guidelines for the investment manager as to what is expected.

While there is no centralized governing body to oversee investment practices of all charities and endowments and to disseminate its findings, we have assembled a panel of experts to discuss these issues with a live webcast on November 27th. This provides you, the charity or endowment, with the opportunity to hear what your peers are doing in their investment portfolio and voice your questions with our investment professionals. Be sure to register today for this dynamic discussion!

[5] Do (Some) University Endowments Earn Alpha? Barber, Brad M., Wang, Guojun, Financial Analyst Journal Volume 69, Number 5, September/October 2013

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