The Prudent Endowment Fund

My first boss in this industry was old school. One of the first things he taught me to help understand the institutional investment landscape was the Prudent Man Rule.

This was a piece of legislation from the 1800s that basically outlined the idea behind being a fiduciary when managing assets for other people. The Prudent Man Rule laid out the idea that fiduciaries need to think about their beneficiaries and not themselves when making investment decisions.

This rule was probably taken too literally back in the day since investors all assumed it meant they should keep most of their money in income-producing assets and focus on preserving capital above all else but it was a step in the right direction.

Stephen Mihm wrote a fascinating piece at Bloomberg last week that discussed how a few colleges finally pushed back against the more stringent aspects of the rule in the 1960s to increase their risk profile:

Bundy commissioned several studies aimed at overturning conventional wisdom. The first, authored by former Securities and Exchange Commission chair William Cary and New York lawyer Craig Bright, laid out a legal strategy for overturning the constraints posed by the "Prudent Man" doctrine.

The second report, published in 1969, argued that universities and colleges should aggressively pursue risk in the quest to increase their endowments. Its principal author, John Barker, an academic and member of Smith College's Investment Committee, compiled data on the performance of 15 elite university and college endowments and found them lacking.
It predicted that a continuation of outmoded investing strategies would have "highly adverse consequences for long-term endowment values."

The influence of these two reports – and subsequent studies commissioned by the Ford Foundation – cannot be underestimated. As one account of this critical phase in investment history has observed, the reports launched a revolution in how universities managed their endowments, ushering in a new "focus on total return rather than capital preservation."

It seems obvious now that a focus on total returns makes more sense for pools of capital that are set up to exist in perpetuity but that's not how institutional investors approached the markets at that time. There were plenty of positives that came about from these changes once people like David Swensen at Yale and Jack Meyer at Harvard implemented new portfolio and investment structures:

- Assets became better aligned with liabilities, time horizons, and cash flow needs.
- Portfolios were set up with a bias towards equities for growth while diversification was used

to manage or reduce risk.
- Asset allocation took center stage to allow for more investment options.

The investment industry knows how to take things too far and in many instances that has been the case for the Endowment Model, as well. The biggest drawbacks of this approach include:

- Much higher fees.
- Illiquid investment structures which lack transparency.
- Increased operational requirements (staff, due diligence, financial resources, etc.).
- Competition from peers for the best money manager talent.

The early adopters of this approach were rewarded with huge gains. But it takes a huge team to be able to pull off the Yale Model and even then you're not guaranteed success. Yale's Swensen explains:

Even with adequate numbers of high-quality personnel, active management strategies demand uninstitutional behavior from institutions, creating a paradox few successfully unravel.

I've described Swensen as the institutional investor equivalent to Warren Buffett in the past but there are other less well-known legends in this space. Scott Malpass falls into this category. He's overseen the Notre Dame endowment fund for three decades with an enviable track record of his own. He also sits on the board at Vanguard and recently told Ted Seides how he reconciles the way he manages money using the Endowment Model with his appreciation for passive investing:

I get asked a lot, "Well you don't do a lot of passive; you're in all these esoteric active strategies; high active risk; you're not benchmark oriented. How does that square with your belief in passive?" I say that it's completely consistent. If I didn't have a team like I have here scouring the world doing 800 meetings a year, looking for the best talent, I would index most of it. If I were running a state [pension] fund at $150 billion, I would index most of it. But I've got a much smaller fund than that and I've got a full team here and we can do this. But most people can't. And I would argue there might only be 50 or 60 investors in the world who really can do this model well. I don't think there's a lot. I think most people should be using one of these other techniques.

Malpass provided some valuable advice and guidance to the investment office I worked for previously as we were setting up the endowment fund. He's a sharp guy who knows a lot about this business and what it takes to run a world-class institutional investment program.

Geraldine Fabrikant wrote a piece in the New York Times a couple weeks ago with a similar prescription for most small nonprofits:

Handling large amounts of money simply isn't a risk-free proposition, and it can be difficult for those without a background in finance.

There is a simple answer, which works for many small institutions as well as for individuals saving for retirement. It is to put money into low-cost stock and bond funds, allocate the money appropriately and rebalance periodically. But the boards of nonprofits don't always find this straightforward approach appealing for a variety of reasons, many of them psychological.

For one thing, not every nonprofit has board members who want to take responsibility for decisions that could affect their institution's financial health. Even members with financial expertise may feel ill-equipped to make an investment decision in a stressful market.

Even those *with* financial expertise may feel ill-equipped to make investment decisions in a stressful market. The first step for institutions is defining who they are and, more importantly, who they are not. Some institutions can thread the needle and handle the requisite work to make the Endowment Model worth the risks but I agree with Malpass that it's a very small number.

It's prudent for investors to understand where they sit on this spectrum before accepting risks they can't handle or don't understand.

Sources:
How Endowments Learned to Love Risk (Bloomberg)
Scott Malpass - The Fighting Irish's 12th Man (Capital Allocators)
Simple Investing for Nonprofits (NYT)

Further Reading:
Priorities

And check out my book on institutional asset management:
Organizational Alpha