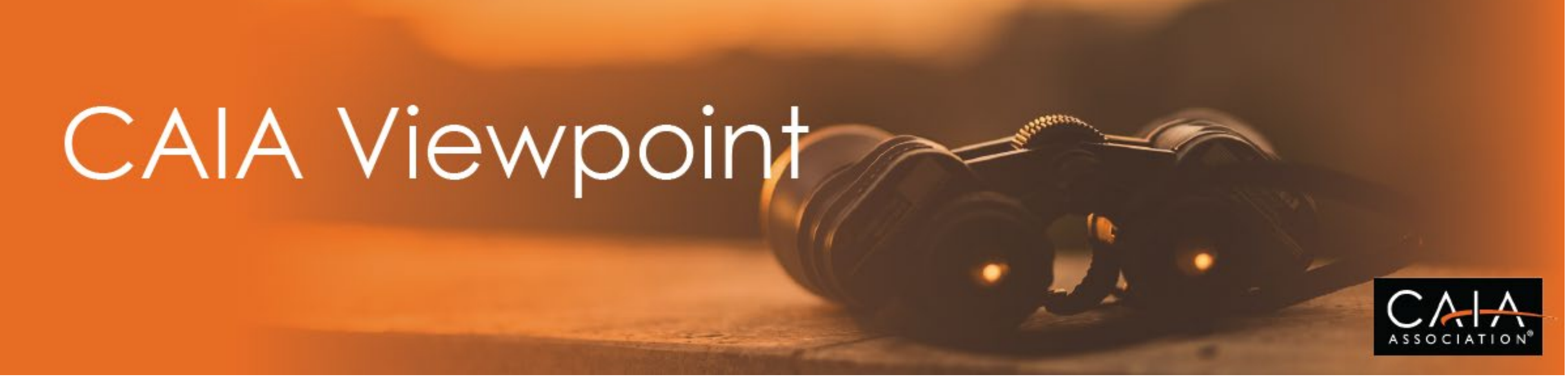

A Simple Approach to the Management of Endowments

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The full article may be accessed here.

Central Issue of the Paper

The CAIA Endowment Investable Index released each quarter in the Alternative Investment Analyst Review was introduced by Hossein Kazemi and Kathryn Wilkens in "A Simple Approach to the Management of Endowments."

Endowments and foundations are tax exempt and charitable organizations that rely on permanent pools of capital to fund their activities. Institutions such as colleges, universities, hospitals, museums, scientific organizations, charitable entities, and religious institutions own these pools of capital. When well-funded and well managed, an endowment can provide a permanent annual income to the organization, while maintaining the real value of its assets in perpetuity. These institutions typically lack the internal expertise to manage their assets. Only the largest endowments and foundations have the resources to build an internal team to manage their assets. Small and medium sized organizations may choose to outsource the management of their assets. However, whether they are small or large, managing the oftentimes illiquid assets that fund these organizations' activities costs money.

What is the point of assuming significant illiquidity risk while spending significant amounts of resources to manage these pools of assets, when over the past 15 years their performances have matched those that can be earned by simple allocations to ETFs?

Approach Employed by Paper

First a non-investable endowment index is created using performance statistics for the largest endowments in the NACUBO-Common Fund Study of university endowments which reports aggregate annual performances of those organizations that report to the National Association of College and University Business Officers (NACUBO). The authors then show that the returns to this non-investable endowment index can be replicated with a combination of ETFs. Specifically, a multi-asset portfolio is created by using an algorithm to select a subset of exposures from 23 equity, fixed income and alternative ETFs. If returns on two asset classes are highly correlated, then the algorithm will pick the one that is less volatile. For instance, if returns on venture capital and small cap stocks are highly correlated, then the program will pick the small cap index if it turns out to be less volatile.

Findings of the Paper

The performance of the multi-asset ETF portfolio, now named the CAIA Investable Endowment Index, has virtually the same returns as the non-investable endowment index with a slightly higher volatility. Yet one must remember that there is smoothing in endowment returns that dampens the reported volatility.

Each quarter the index is updated, and the exposures of the Multi-Asset ETF portfolio are displayed through time. It is important to note that the volatility displayed by these exposures does not imply that endowments alter their asset allocations as frequently as the Multi-Asset ETF portfolio. While an endowment may hold a fixed allocation to various asset classes, the underlying assets/manager may display time-varying exposures to different sources of risk. For instance, a hedge fund manager may decide to increase her fund’s exposure to energy stocks while reducing the fund’s exposure to healthcare stocks. Though the endowment’s allocation to that manager has remained unchanged, its exposures to energy and healthcare sectors have changed.

The largest allocations suggested by the algorithm, as of the last update, were to the MSCI world Free ETF (33.9%), Russell 2000 ETF (24.3%), and SPDR Dow Jones Global Real Estate ETF (16%).