Understanding the Cost of Investment Management

October 2015

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About Commonfund Institute

Commonfund Institute houses the education and research activities of Commonfund and provides the entire community of long-term investors with investment information and professional development programs. Commonfund Institute is dedicated to the advancement of investment knowledge and the promotion of best practices in financial management. It provides a wide variety of resources, including conferences, seminars and roundtables on topics such as endowments and treasury management; proprietary and third-party research such as the NACUBO– Commonfund Study of Endowments; publications including the Higher Education Price Index (HEPI); and events such as the annual Commonfund Forum and Commonfund Endowment Institute.

Understanding the Cost of Investment Management

A guide for fiduciaries

Introduction

Few aspects of financial management are more important for fiduciaries than an understanding of the costs paid for the management of the perpetual funds for which they have responsibility. Indeed, astute management of costs can make the difference between mediocrity and superior performance in otherwise identical portfolios. But unlike other factors that affect investment returns, such as asset allocation and the many types of operational and investment risk, costs are almost certainly the least well understood. In this paper, we introduce the various types of costs that investors pay – both disclosed and undisclosed – and provide representative ranges for each type of cost. Our aim is to guide fiduciaries as they strive to fulfill their duties under common and statutory law and to provide investment managers with a guide to best practice.

Commonfund Institute's national surveys of endowments and foundations confirm a low level of understanding with respect to costs. To take one example, of the 832 U.S. institutions of higher education participating in the 2014 NACUBO-Commonfund Study of Endowments® (NCSE), the 717 that responded to the suite of questions regarding costs incurred in managing their investment program estimated a median all-in cost of 50 basis points, or 0.5 percent. But very few of these institutions were able to provide specific breakdowns, although most could name the components of those costs by category. And while some cost categories were clearly familiar, others were cited less frequently. For example, 86 percent said that their cost total included asset management fees and mutual fund expenses; 64 percent cited consultant and outsourcing fees; and 56 percent included direct expenses. But only 18 percent included incentive and performance fees paid to asset managers, despite the fact that nearly 85 percent of NCSE respondents, or 704 institutions, reported having asset allocations to alternative investment strategies. Clearly, a gap exists between practice and understanding with respect to certain types of costs. [1]

In a similar vein, in early 2015 Commonfund conducted a survey of the fiduciaries – financial officers and trustees – attending the Commonfund Forum annual investor conference. In response to the question, "What are the total fees and expenses you pay to investment advisers, managers, consultants and custodians (in basis points)?", 81 percent of the 193 survey respondents estimated their annual costs at less than 100 basis points, while 19 percent said their costs were greater than 100 basis points. Eighteen percent of respondents estimated their costs at less than 50 basis points, while 14 percent put them at over 130 basis points.

These data points support a few preliminary observations. As the NCSE responses point out, the categories that are included in overall cost estimates vary widely. In addition,

1 For a more detailed review of the NCSE and other Commonfund Institute data on costs, see the Appendix, "What We Know about Costs".

the fact that almost 15 percent of NCSE participants did not provide cost data at all suggests that they may not have known what their costs were or were uncertain about them.

A more detailed estimate of total costs comes from Commonfund's investor services group, which analyzes costs for some 80 client organizations each year. The results of these analyses suggest that costs are significantly higher than the median 50 basis points reported in the NCSE. In general, average costs appear to be no less than 100 basis points and can range up to 175 basis points or more for more complex portfolios. It is this level of detail that is missing from the self-reported numbers, and which we hope to illuminate here.

A range of factors may cause costs to vary from institution to institution, even among those of similar size and type. But it is clear that a fuller understanding of the costs associated with managing institutional nonprofit funds is needed. In this paper, we attempt to accomplish three goals:

- To provide an overview of the various types of costs, both disclosed and undisclosed, that nonprofit institutions are likely to incur in investing their long-term pools, together with representative cost ranges;
- To help fiduciaries to understand the derivation of these costs; and
- To enable them to address well-informed questions about disclosed and undisclosed costs to investment service providers.

Why Costs Matter

Fees are known – indeed, they are frequently set out in detail in a manager's or service provider's invoice – and can, therefore, be analyzed and controlled. Costs, on the other hand, are not necessarily invoiced and can be much harder to understand and control. The problem is exacerbated by the fact that different types of long-term investment pools report their investment performance in different ways. Nonprofit organizations such as colleges, universities, independent schools, foundations, operating charities and healthcare organizations generally report their investment results net of costs. The practice among public pension plans, however, is typically to report returns in gross terms. Because fees and costs – both disclosed and undisclosed – determine what institutions get to keep and spend in support of their missions, it is important to understand their nature and range. Furthermore, as a fiduciary matter, several compelling reasons exist to support a better comprehension of cost issues:

- As transparency becomes the norm in the nonprofit sector, driven by the disclosures required by the expanded IRS Form 990 and by social forces that encourage increased openness, trustees and senior staff are expected to understand the total cost that their organization pays for investment management as part of their fiduciary duty of care.
- The "endowment model" of a highly-diversified portfolio with a high allocation to illiquid investment strategies, frequently in the form of limited partnerships, often contains compensation structures that include incentive fees and other forms of potential income for the general partner, many of which are not clearly disclosed. It is incumbent upon fiduciaries to have some understanding of what these fees are likely to encompass and what their range could be.
- Even in traditional long-only investment strategies – such as, for example, core fixed income – where the dispersion of gross returns is relatively narrow, higher asset management fees can mean that a manager that would rank in the first quartile in terms of gross performance may become just average when viewed in terms of net performance after fees.
- High costs are more visible when markets are trending down, since they add to losses. If, as many investors expect, the next few years will be characterized by more subdued returns after years of high performance, fees will be felt more acutely.
- In a purely economic sense, institutions should be willing to pay more for "alpha", or excess returns due to manager skill, than for "beta", or market returns. Beta is readily available at low cost through passive or indexed investment vehicles, so it is important not to pay active management fees for simple beta exposure.

- Finally, while fees are rarely noted in surveys as being among the most important criteria in manager selection, they are frequently cited as one of several key deciding factors.

The fiduciary duty to understand and manage costs is embodied not only in common law principles but also in statutory law. The Uniform Prudent Management of Institutional Funds Act (UPMIFA)[2], the dominant law governing investment, spending and delegation from donor-restricted funds, demands prudent oversight of the cost of investment management. Section 3 of UPMIFA directs an institution to incur only "appropriate and reasonable costs" in managing its investment portfolio. Determination of what satisfies this standard is left to the fiduciaries, who are expected to act "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances."

Furthermore, as we have noted, the revised Form 990 extends its reach to the issue of costs, asking, among other queries, what an institution pays for portfolio management.

The Structure of Costs

Viewed from the point of view of institutional structure, four factors influence the types of costs that it is likely to incur. We have referred to these in general terms, but will now review them in more detail. They are:

- The institution's policy portfolio
- The size of its investment pool
- The investment vehicles it uses
- Its investment model

Policy Portfolio

An institution's policy portfolio exerts a strong influence on its investment costs. In particular, the use of alternative investment strategies such as marketable alternatives and private capital changes the cost profile of an institution because the cost structure of these strategies is significantly higher than that of traditional long-only liquid asset classes, whether the latter are actively or passively managed. Another factor influencing costs is the number of managers used. Highly-diversified endowments have policy portfolios that may contain more allocations to specific niche strategies. As a result, they are likely to employ more managers than less-diversified institutions. One way to examine this effect is to compare larger endowments, which tend to be more diversified, with smaller, less-diversified ones. In the Council on Foundations-Commonfund Study of Foundations (CCSF) for FY2014, private foundations with assets over $500 million reported having an average of 59.2 direct alternative managers while those with assets under $101 million reported an average of just 2.7 such direct relationships. Similar patterns were observable for community foundations and, in the NCSE, for educational endowments. As is well known, larger funds have more leverage in negotiating lower fees from managers and service providers. But quite apart from the issue of these managers' fees, the need to analyze, monitor and supervise a greater number of management firms in a wider array of strategies necessarily contributes to higher costs, whether borne via internal staff or through outside consultant or outsourced chief investment officer (OCIO) relationships.

Portfolio Size

As noted, portfolio complexity tends to increase with the size of the asset pool. Larger endowments typically have proportionally larger allocations to alternative investment strategies, which generally carry higher asset fees, incentive costs and other expenses, than do smaller and mid-sized endowments. For example, as reported in the most recent NCSE, endowments with assets over $1 billion reported allocating an average of 57 percent of their portfolio to alternative investments, while institutions with endowment assets under $25 million had only a 10 percent allocation. The reverse held for allocations to domestic equities and fixed income securities, where smaller endowments reported significantly greater proportional allocations to these traditional asset classes. Similar patterns were reported by organizations participating in the most recent CCSF. There can thus be said to be a direct relationship between portfolio size, viewed as a proxy for complexity, and overall investment costs.

2 The text of the law, together with commentary, may be viewed at http://www.upmifa.org.

Investment Vehicles

Whether an institution's investment pool is large or small, its choices regarding the vehicles through which it will implement its policy portfolio have consequences for costs, since different investment vehicles carry different cost structures.

One of the most fundamental issues for those who determine investment policy is the choice between active management, which normally incurs a higher cost in its search for alpha, and lower-cost passive management which accepts the beta returns that come from the market without seeking more. Many institutions opt for a mix of active and passive strategies, anchoring a portion of an allocation – the "core" – in a passive beta strategy while assigning other portions to active managers in whom the institution has a high degree of confidence to deliver alpha from particular niche strategies.

Another structural decision that can influence costs is whether the institution uses separate accounts or instead invests via commingled funds. While separate accounts are usually available only to institutions with larger amounts to commit, the costs of separate accounts can be fairly easy to calculate since they are set out on the manager's invoice, to which the institution can add its custody, consultant and other expenses. Commingled funds, on the other hand, can be more difficult: expenses may be imbedded in the fund; there may or may not be an invoice; and custody is sometimes included in the price of the fund, but not always. Mutual funds adhere to tightly regulated reporting requirements, but understanding their fee structure can be vexing nevertheless. Funds may or may not charge wrap fees, 12(b)1 and other fees to cover marketing and promotional expenses.

Limited partnership structures, as we have mentioned, raise additional issues. While many activities are included in the general partner's management and incentive fees, others are not. In the absence of an industry standard, it is necessary for limited partners to conduct a detailed analysis of the terms and conditions contained in the partnership documentation to be able to calculate the actual charges that are being assessed, which may include fees for transactions and other activities undertaken by the general partner on behalf of the limited partnership.

Finally, particularly with respect to alternative investment strategies such as hedge funds and private capital, one of the most important decisions affecting costs is whether to invest directly with the managers or via a fund of funds. The fund of funds approach means incurring two layers of fees, for the underlying manager and the fund of funds manager. But because successful alternative strategy managers often limit the size of their funds in order to avoid diluting returns, institutions that do not have direct access to those managers may find it necessary to invest via funds of funds that have long-standing relationships and receive regular allocations. If the underlying managers are able to deliver first-quartile net performance on a consistent basis it may make more sense, for reasons both of access and of staff efficiency, to invest via a fund of funds, even after accounting for the added expense.

Investment Management Models

The fourth factor influencing costs is which of the investment management models in general use the institution decides to employ.

- Traditional consultant model – In this model, the internal staff (if any), outside managers and the consultant all report directly to the investment or finance committee. The consultant guides the committee in the formation of investment policy at the strategic level, researches and proposes slates of potential managers, and assists the staff with performance evaluation. For ongoing due diligence and monitoring of managers, the institution must either build a staff or pay the consultant to perform these tasks. As the institution's portfolio grows more complex, the costs associated with oversight of a large number of direct manager relationships become higher – a factor which has, over the last decade, fueled the growth of the outsourced chief investment officer model described below.

- Internal CIO model – Here, the institution has a chief investment officer (CIO) who reports to the investment or finance committee. The CIO hires outside managers and may also engage in some direct investing. The investment staff report to the CIO, and routine communications with outside managers and direct investments are their responsibility. It goes without saying that the costs associated with hiring, retaining, evaluating and compensating a talented CIO and staff can be considerable; for that reason, CIOs tend to be found at institutions with larger endowments that can benefit from, and bear the costs of, this structure.

- Fund of funds (or manager of managers) model – The fund of funds manager reports to the investment or finance committee, with a close liaison with the investment staff. Monitoring of the underlying managers or subadvisors is the responsibility of the fund of funds manager, a structure which can be cost-efficient compared to the burden of overseeing many direct manager relationships. A consultant may also be present to assist with portfolio construction and monitoring of the fund of funds manager.

- Outsourced Chief Investment Officer (OCIO) model – Internal investment staff and the OCIO report to the investment or finance committee; outside managers report to the committee via the OCIO provider, with a close liaison with the investment staff. The OCIO may be a stand-alone firm, a fund-of-funds manager or a division of a consulting firm.

As can be readily discerned, the model that is chosen will influence the way in which investment decisions are made and, in turn, the cost structure. The traditional model, in which trustees or a delegated finance or investment committee hire outside managers for various investment strategies, becomes less practical as the portfolio increases in complexity. Volunteer fiduciaries, meeting a few times a year, are frequently unable to take advantage of swiftly-developing market opportunities, keep pace with legal and compliance demands and monitor a range of risk factors, even with the assistance of an outside consultant and one or two staff members. On the other hand, building a competent internal staff with a dedicated CIO can be expensive, and it can be difficult for a small- or medium-sized institution to retain a talented CIO over the long term. For this and other reasons, while the fund of funds model is still employed by many institutions the use of the OCIO model has grown over the last decade to the point at which an average of between 35-40 percent of private and community foundations and educational endowments participating in the CCSF and NCSE now report that they have adopted an OCIO structure.

Understanding Cost Components

Costs generally fall into four basic categories:

- Costs related to portfolio construction and management
- Activity- and transaction-related fees and costs
- Fund servicing costs
- Investment oversight costs

Within each category, some costs are charged directly, or invoiced, while some are netted from the fund. This dual system of charging can make it difficult to assess actual expenses. In addition, certain items such as direct management costs can straddle the two areas. In this section, we review each cost component.

Portfolio Construction and Management

Direct investment management fees — As we have noted elsewhere in this paper, these can vary widely depending on the asset class and whether the strategy is active or passive, among other factors. An index fund may assess a modest fee, frequently less than 20 basis points, while an actively managed fund will typically be more expensive, with fees ranging from 50-100 basis points depending on the nature of the strategy and the amount invested. Hedge funds, private capital and real estate tend to be more costly still, with asset management fees in the 1-2 percent range. This variability in asset allocation accounts for much of the wide range of fees paid by institutional investors.

In this regard, some institutions use the concept of a "fee budget", which comprises the total fee amount that they plan to spend. Within that, they may choose to allocate a portion to some managers that are expected to generate alpha, while obtaining their beta cheaply via an index strategy.

Carry or incentive fees — These terms describe the profit share that the manager of a limited partnership is entitled to keep under the terms of the partnership agreement. It is usually expressed as a percentage of the net profits from the strategy, but it may alternatively be calculated as the excess over a minimum threshold level of returns, or hurdle.

Most hedge fund and private capital managers charge an incentive fee of 15 to 20 percent of net profits. Some private capital managers, particularly those that have successful track records in venture capital, charge up to 30 percent of profits, sometimes over a benchmark. Real estate funds generally charge 20 percent over a hurdle rate.

Activity- and Transaction-Related Fees and Costs

Trading and brokerage costs — These services can be difficult to measure because they are generally not reported in the total cost of investment management. Commissions are fees charged by a market intermediary to execute a transaction on exchange-traded instruments. For equities, the commission is usually calculated in terms of cents per share; for futures, it is calculated as dollars per contract. On the fixed income side, trading and brokerage costs are generally modest for deeply liquid markets such as U.S. Treasuries, with bid/ask spreads ranging from half of a 32nd to as high as 3 to 5 basis points for subprime or high yield vehicles. Commissions for asset-backed securities are about 10 basis points.

Market impact —the effect of a decision to execute a trade and the volume of that trade—is another transaction cost. The act of purchasing or selling a security moves markets. While commissions are relatively easy to calculate, market impact is not. The larger the transaction or the more illiquid the market, the higher the impact. For many funds, market impact can exceed commission cost. For example, a hedge fund manager may move in and out of an investment very quickly, resulting in a sizable market impact. Conversely, long-only managers may tend to enter or exit a particular investment over time in order to minimize market impact.

Some firms, Commonfund among them, employ an outside service to monitor and minimize trading and brokerage costs. This service examines the actual cost of each transaction by security, manager and fund. The quarterly report that is produced enables Commonfund to examine issues related to best execution, including commissions and market impact.

Prime brokerage fees — These fees are typically found embedded in hedge fund costs. They include items related to securities lending, clearance and settlement, reporting, leveraged financing, covering of short sales and related services, all areas that are potentially very profitable for broker-dealers. While it is difficult to calculate prime brokerage account fees, fiduciaries and their advisors should be aware of them and seek to determine a working understanding of how they affect returns for the funds in which they invest.

Fund Servicing Costs

Operating costs of commingled funds are typically embedded within the fund’s net asset value. Investors in commingled vehicles can assess the impact of these operating costs by reference to the expense ratio that is disclosed in the fund’s audited financial statements or other fund reporting. However, in a fund of funds structure, the reported ratio may not include all operating costs of underlying funds. Investors should be mindful of these “look-through” costs in assessing the overall cost profile, and work with the investment manager to ensure that they have a complete picture of costs in the fund. The following are typical operating costs of commingled funds:

Custody fees — These amounts are charged for safekeeping of assets as well as recordkeeping of fund or portfolio positions and transactions. They will often include fund accounting as a bundled service. They are generally regarded as a cost of investment management and are typically a component of direct costs that are assessed at the fund level. They can vary depending on the type of holdings and transactions, with some custodians charging only a few basis points for a held asset but then assessing high transaction fees. This can be a particularly significant issue in markets outside the U.S., where some sub-custodians charge the transaction fee as a fixed dollar amount, regardless of the transaction size, leading to a charge that can be relatively high for small transactions and relatively low for large transactions. As an example, these costs, which are generally 5 to 10 basis points for U.S. funds, rise to 10 to 25 basis points for large international funds and can easily exceed 25 basis points for small international funds.

Audit fees — These fees, which are understandably dependent on a fund’s structure, valuation and complexity, are charged as fixed dollar amounts are therefore will vary in percentage terms based on the asset level of the fund or portfolio that is being audited. For funds, these costs will generally range from 1 to 10 basis points. They have increased in recent years following the pronouncement by the American Institute of Certified Public Accountants

Calculating Costs

How to Compute What You Actually Pay

The following methodology may be of use in helping you to understand more fully what your organization pays for investment management.

Identify the fees you pay at the overall portfolio level ("overlays")

- Consultant fees
- Investment office fees and expenses
- Wrap fees
- Other portfolio fees

Key question: What are the specific services being provided and how are you paying for them? Be mindful of providers who promise that "everything is included."

Identify fees you pay at the fund level for each investment vehicle

- Manager direct fees
- Performance fees
- Fund of fund fees

The types of vehicles in which you are invested make a difference; commingled funds and partnerships can have hidden expenses. Also try to understand how funds are aggregated to reach fee breakpoints.

Key question: What fees are paid explicitly and what expenses are embedded in the performance of the fund?

Identify the activity and transaction-related expenses that are assessed within each investment (or by each manager)

- Trading and brokerage
- Prime brokers
- Custody, net of securities lending, if applicable

Very few investment managers break out trading and brokerage costs as a subset of direct expenses. It is important to question your managers about how they strive for the best execution possible in all trading.

Key question: How do you ensure that you have the best possible execution of trades to keep transaction and brokerage costs low?

Identify the activities required for administrative oversight and management of your portfolio

- Audit and legal
- Administrator
- Staffing and benefits
- Infrastructure and facilities

Key question: What are the outputs you receive that enable you to oversee your portfolio, and what are the costs associated with producing them? Examples include risk analytics and consolidated reporting.

(AICPA) regarding the determination and audit of fair market valuation on alternative assets. Fees are subject to negotiation, particularly if the fund holds sizeable assets.

Legal fees — These have risen in recent years, and now generally range between 1 and 3 basis points, depending on fund size. Setting up a fund generally incurs $50,000 to $75,000 in elemental startup costs, while costs for establishing a simple separate account can range from $5,000 to $10,000. Additional organizational expenses can vary significantly depending on the complexity of the structure and legal terms, sophistication of fund counsel, and amount of negotiations involved. Similarly, ongoing legal services, covering document retention, updates to governing documents and a wide range of other items, can vary widely, ranging from zero to $25,000 per year.

Administrative fees — Administrative services, including performance, tax and compliance reporting and fund administration, generally cost 2 to 5 basis points, but can vary depending on the services selected. They are usually bundled with custody and fund accounting fees.

Investment Oversight Costs

Overhead expenses — This item generally refers to internal legal and other staff, information technology, reporting, facilities management and similar charges. Again, it is largely dependent on the size and nature of the institution's portfolio and its ability to employ and retain expert internal staff as opposed to outside suppliers.

Ongoing oversight costs — There are four types of these costs:

- *Brokerage wrap fees*: If a broker—especially one functioning as a consultant—places an institution's funds with individual money managers, a wrap charge of 50 to 100 basis points will commonly be applied to cover ongoing oversight and transaction costs of those managers by the broker.

- *Consultants* charge a retainer fee of $25,000 to $150,000 or more, depending on the size and complexity of the portfolio and the services included in the retainer. There can also be an hourly fee for such activities as manager searches, reports, telephone calls and investment committee visits. In some instances, the hourly fee may be credited against the retainer. Some consultants have themselves become investment managers or OCIOs, charging 20 to 60 basis points for access to and management of investment managers.

- Larger institutions may decide to establish an *independent proprietary management office*, in which they hire their own expert investment staff to purchase and sell securities directly instead of, or in addition to, using outside managers. The cost of such an office naturally varies depending on its staffing requirements; examples exist with from one to 180 employees.

- *Fund-of-funds managers* apply a fee for selection and management of fund managers in addition to passing through to the investor the underlying fees associated with those individual managers. This fee varies depending on the asset class and the size of the investment. Traditional asset classes generally command 5 to 40 basis points; hedge funds, 50 to 100 basis points plus incentive fees of 5 percent to 10 percent; and private capital, up to 200 basis points plus an incentive of 10 or 20 percent.

Outsourcing Costs

Overview

The costs associated with using an OCIO structure vary widely, depending on the scope of the delegation and the degree of discretion, control and authority the institution wishes to build into its relationship with the provider of outsourced investment management services. Some institutions may prefer that the investment committee and staff retain hands-on control, remaining involved in all investment decisions. Other institutions and committees may want to delegate essentially the entire investment function to the OCIO provider, retaining approval of only the highest level portfolio policies, such as the setting of strategic asset allocation targets.

The unique service desires of each institution have led to a lack of standardization among OCIO models. In the absence of a common denominator to foster comparison of services, it has remained very difficult to compare fees. This is particularly true when considering that the only way for an institution to obtain the services provided by an OCIO would be for it to hire, retain, compensate and evaluate a comparable investment staff of its own, which would almost always be more expensive unless the fund is large enough – above, say, $2-3 billion – to enable it to spread those costs across the asset pool.

Factors to Consider

When negotiating with an OCIO provider, fiduciaries should ask the following questions in order to clarify what is included in the OCIO provider's service agreement:

- Does the agreement contain all the potential categories of costs? Are certain components to be assessed separately?

- What services are included in these cost categories, and what are not? While an OCIO advisory fee is typically charged, other charges may include direct expenses, performance fees and base asset manager fees, among others.

- As you compare the fees charged by various OCIO providers, are you basing your comparison on equivalent models? Among the key factors to consider are degree of discretion, size and scope of the mandate, frequency and depth of communication, and roles and responsibilities of the OCIO firm.

- Does the OCIO provider treat similar clients the same for fee purposes?

- Does the provider share fees with sub-advisors or through proprietary management?

Assessing Costs

Generally, fees for outsourced management are calculated in addition to investment management fees. According to a recent study, the outsourcing provider "typically charges a fee as a percent of AUM that ranges from 30-100 basis points" of assets under management.[3] Some managers, however, charge only the investment management fee and receive no fee for the outsourcing service as such. Some providers may charge an incentive fee in addition to their base fee, and for specific mandates—alternative strategies, for instance—some may charge a premium.

For these reasons, it is incumbent on fiduciaries to ask for performance data and fee information in a format that enables them to evaluate and compare providers.

Conclusion

While investment returns are difficult to forecast with any degree of precision, it should in principle be possible for fiduciaries to achieve a good understanding of costs and fees. Yet they remain one of the most complex variables for many institutions. This lack of clarity may be due in part to the tremendous changes that have taken place in the structure of long-term portfolios in recent decades. Institutions that grew accustomed to paying 50 to 100 basis points for traditional, long-only equity management now encounter multiple fee structures across a range of traditional and alternative asset classes and strategies, supported by evolving and more complex relationships with consultants and OCIO providers. A better understanding of fees is also hindered by a lack of standardization and by the difficulty associated with ascertaining what is and is not included—or hidden beneath the surface—by providers when they quote fees for various services.

In the final analysis, costs in themselves are less important for most institutions than achieving the investment objective of a level of long–term, risk-adjusted return that will enable them to fulfill their missions. Inevitably, however, costs and fees must be considered among the most potentially decisive factors affecting portfolio performance. The process of achieving an understanding of these fees, while challenging, should result in a better comprehension of the relationships between the portfolio's investment risk, return and expense structure over the long term.

3 R.V. Kuhns & Associates, Inc., "Considering the OCIO Option: Not an Everyday Decision for Fiduciaries," February 2013. http://www.iiforums.com/cfr/presentations/cfr13-ocio.pdf.

APPENDIX: What We Know about Costs

Most institutions are able to estimate some of their costs. Commonfund Institute's annual surveys of educational institutions and foundations, which provide information about reported costs and their components, constitute a starting point from which to begin an analysis. But while participating institutions are able to estimate the costs that are clearly disclosed to them, they are, overwhelmingly, unable to provide other types of cost or to break down their costs in finer detail.

An examination of the cost data reported in our two surveys of educational endowments and private foundations illustrates this point. In the 2014 NCSE, 717 private and public colleges, universities and support foundations (institution-related foundations, or IRFs) supplied data regarding the total overall internal and external costs of running their investment programs. These institutions estimated that the average cost of managing their investment programs in FY2014 was 63 basis points, unchanged from the prior fiscal year. The median reported cost was 50 basis points, just two basis points below the figure reported for FY2013. The following table summarizes the average and median costs reported in basis points and the average cost in dollars for all responding institutions by endowment size:

COST OF MANAGING INVESTMENT PROGRAMS FOR FISCAL YEAR 2014

NACUBO-Commonfund Study of Endowments

	Total Institutions	Over $1 Billion	$501 Million -$1 Billion	$101 - $500 Million	$51 - $100 Million	$25 - $50 Million	Under $25 Million
Responding Institutions	**717**	**54**	**62**	**233**	**154**	**118**	**96**
Average cost ($ in thousands)	1,917	14,248	5,219	1,507	335	195	73
Average cost (basis points)	63	66	81	68	53	58	61
Median cost (basis points)	50	48	58	56	43	45	48

The first point to note in analyzing this information is that, unlike the responses for many other topics surveyed in the NCSE – for example, asset allocation – there is no discernable pattern by asset size. In fact, the very largest endowments appear to pay less than the next-largest group – a counterintuitive result considering that, while they may be eligible for price reductions based on the scale of the assets they are able to commit, these institutions have the most complex portfolios, with the highest allocations to private alternative investment strategies that attract incentive and other fees. This apparent inconsistency in the data indicates that it is essential to use caution in drawing broad conclusions from these numbers, and we point this out in the NCSE report.

The same problem exists with respect to foundations, where the institutions participating in the FY2014 Council on Foundations-Commonfund Study of Investment of Endowments for Private and Community Foundations (CCSF) reported an average cost of 73 basis points for private foundations and 76 basis points for community foundations, with a median cost of 61 and 75 basis points, respectively. Both were somewhat higher than the figures reported for FY2013, which were an average of 71 basis points and a median of 62 basis points for private foundations and an average of 79 basis points and a median of 78 basis points for community foundations. Again, it is notable that there is no apparent correlation between fees paid and the size of the foundation's asset pool.

COST OF MANAGING INVESTMENT PROGRAMS FOR FISCAL YEAR 2014

Council on Foundations-Commonfund Study of Investment of Endowments for Private and Community Foundations

	Total Institutions		Over $500 Million		$101 - $500 Million		Under $101 Million	
numbers in percent (%)	Private	Community	Private	Community	Private	Community	Private	Community
Responding Institutions	**126**	**88**	**20**	**10**	**66**	**28**	**40**	**50**
Average cost ($ in thousands)	4,383	1,085	19,081	4,577	1,220	2,390	290	196
Average cost (basis points)	73	76	85	78	69	91	74	67
Median cost (basis points)	61	75	61	87	60	85	61	63

In an effort to understand what lies behind these overall figures, we have for a number of years asked institutions participating in the NCSE and CCSF to itemize their total costs in detail using a list of expense categories. Here, the results are somewhat more encouraging. While the number of institutions able to provide a basis-point breakdown of their cost components is negligible, most are able to indicate what categories of cost component make up the total figure that they report. Here, too, in contrast with the overall cost figures, there is a clearer correspondence between the presence of certain cost components and endowment size. For example, as the following table from the FY2014 NCSE shows, while 56 percent of responding institutions include direct expenses (e.g., sub-advisory fees, audit fees and record-keeping expenses) in their estimate, the figure ranges from 90 percent for educational institutions with between $501 million and $1 billion in endowment assets to just 33 percent of those with assets under $25 million. In a similar vein, reflecting the presence of higher numbers of internal investment staff at institutions with larger endowments, 79 percent of institutions with assets over $1 billion include expenses related to internal staff while just 5 percent of institutions with assets under $25 million do so (the average for all institutions is 19 percent).

INCLUDED IN COST CALCULATIONS FOR FISCAL YEAR 2014

NACUBO-Commonfund Study of Endowments

numbers in percent (%)	Total Institutions	Over $1 Billion	$501 Million -$1 Billion	$101 - $500 Million	$51 - $100 Million	$25 - $50 Million	Under $25 Million
Responding Institutions	**685**	**53**	**61**	**225**	**147**	**107**	**92**
Asset management fees and mutual fund expenses	86	77	85	91	84	79	87
Direct expenses	56	85	90	67	44	36	33
Incentive/performance fees paid to asset managers	18	34	34	22	12	7	7
Internal staff	19	79	52	20	3	3	5
Consultant/outsourcing fees	64	79	87	80	56	45	38
Other	9	26	30	8	5	4	2

NOTE: multiple responses allowed

Data from the CCSF show a similar overall correlation between private foundation size and what is included in cost calculations.[1] Among noteworthy differences are consultant and outsourcing fees, which are included by 73 percent of the largest participating private foundations but only 56 percent of the smallest. Once again, internal staff costs are included by 33 percent of the largest private foundations, but only 9 percent of the smallest.

INCLUDED IN COST CALCULATIONS FOR FISCAL YEAR 2014

Council on Foundations-Commonfund Study of Investment of Endowments for Private and Community Foundations

	Total Institutions		Over $500 Million		$101 - $500 Million		Under $101 Million	
	Private	Community	Private	Community	Private	Community	Private	Community
Responding Institutions	**108**	**74**	**15**	**9**	**59**	**24**	**34**	**41**
Asset management fees and mutual fund expenses	85	82	73	*	85	83	91	78
Direct expenses	64	51	67	*	66	63	59	37
Incentive/performance fees paid to asset managers	19	5	27	*	20	4	15	5
Internal staff	26	11	33	*	34	17	9	5
Consultant/outsourcing fees	59	58	73	*	58	75	56	41
Other	6	4	7	*	3	0	9	5

NOTE: multiple responses allowed
**sample size too small to analyze*

1 The sample size for the largest community foundations was too small to analyze.

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