

Russell Research

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Russell's model portfolio framework for endowments and foundations

Building the right investment structure for an endowment or a foundation is a complex challenge. Strategic questions such as investment objectives and return targets quickly lead to a daunting array of other questions: the role of alternatives, implementation issues, questions of risk, and how to find the right investment vehicles to put the strategy into effect, among many others.

To help our clients face this challenge, Russell uses a model portfolio framework that helps institutional investors such as endowments and foundations address the choices systematically, and create well-structured portfolios that take into account their specific objectives resources and circumstances.

The challenge – reduce reliance on public equity markets

Despite the big steps that some (mostly very large) endowments and foundations have taken towards alternative asset classes, it remains the case that, for most of this market, there is still a very heavy concentration on public equity markets as a source of investment return. While the high profile Yale University Endowment, for example, has just 25%¹ of its assets invested in the stock market, this is not typical: the average university endowment has 47%², and the average foundation has 52%³.

These allocations represent an enormous concentration of risk. Indeed, by our calculations, 98% of the variance in returns of an investor with 45% invested in U.S. equity indexes, 20% in non-U.S. equity indexes and 35% in fixed income indexes can be attributed to equity market volatility⁴. Add in traditional active management associated with those asset classes and the figure only falls to 96% - the return pattern is still completely dominated by the performance of equity markets.

Responding to the challenge – Russell's model portfolio framework

Most endowments or foundations are looking for fairly high levels of return from their investments: often somewhere in the range 7% to 10% annually (or 4-7% after the effect of inflation). If the reliance on equity markets is to be reduced, then alternative sources of

return must be found if those targets are to remain achievable⁶. So the key questions must be asked: what are the best sources of return and how can the average endowment access them?

Our model portfolio framework uses four steps to help answer these questions.

STEP 1: SEEK DIVERSIFIED EXPOSURE VIA SYSTEMATIC RETURNS (BETA) FROM PUBLIC MARKETS

While the Russell model portfolio framework relies less on equity markets than traditional investment approaches, these markets still play an important role at the core of sound investment programs, along with the systematic returns (or beta) available from other publicly-traded markets.

There's a lot that is appealing about these sources of return: they are relatively easy (and cheap) to access; there are many strategies and products to choose from; and, because these types of investments are familiar, boards are usually comfortable with the exposure and the risks they entail. Consider the typical board's reaction to a 10% drop in equity markets over a few weeks, reducing the value of the total investment holdings by 5%. Then compare that to how a 5% loss in the total value of the holdings would be seen if it happened for any other reason. Familiarity has bred comfort.

Even within public markets, most endowments or foundations do not take advantage of the full breadth of available opportunities. Global equity strategies range from traditional large cap mandates to niche strategies such as frontier emerging markets and micro-cap, while fixed income strategies range from treasuries through high yield, emerging markets and distressed debt. Other categories fall into the public market arena including public real estate (REITs), collateralized commodity futures and listed infrastructure.

STEP 2: ADD SKILL-BASED (ALPHA) STRATEGIES

One way to diversify away from equity market beta as a source of return is to place greater emphasis on skill-based (alpha) strategies. Potential sources of alpha have widened tremendously in recent years. In addition to traditional long-only active management mandates, there is a growing opportunity set with strategies associated with alpha extension (e.g., 130%/30%), diversified hedge fund approaches, global tactical asset allocation, specialist active currency management, exposure management, and more.

STEP 3: ADD TOTAL RETURN STRATEGIES WHERE ALPHA AND BETA CANNOT BE SEPARATED

Not every investment opportunity can be neatly split into its systematic (or beta) and skill-based (or alpha) parts. These include some major, diverse, global private or less liquid investments that are becoming increasingly accessible to many institutional investors. Under the general heading of private real estate, for example, would fall traditional "core" mandates which typically would lie somewhere between equity and fixed income on the risk/return spectrum, but other opportunities in this category include the more aggressive areas of value-added and opportunistic real estate. Likewise private equity spans a number of strategies including secondaries, leveraged buyouts and venture capital. Private infrastructure also offers a range of risk/return profiles from the more bond-like mature investments to private-equity like greenfield opportunities.

STEP 4: BE OPPORTUNISTIC

The fourth step in the Russell model portfolio framework is to explicitly open the door for constant review of the investment structure and to make space for tactical shifts in response

to market developments. Many endowments and foundations have investment processes and structures that create barriers to the consideration and implementation of new opportunities. But some of the most successful investors have been the ones that instead sought out and embraced them. Few non-profit organizations have the resources of a Yale, Harvard, or the Ford Foundation, and we do not recommend that they attempt to replicate the processes that those better-resourced organizations have built. But, opportunistic strategies can nonetheless often be included even in less exalted programs through the use of vehicles such as directional hedge funds (most of which we would categorize as opportunistic investors, as opposed to their non-directional low-beta counterparts, which sit more naturally into the “alpha” step.)

Implementation

If the benefits of diversification are to be maximized, then strategies need to be looked at in the context of the total portfolio, and risk should be assessed in terms of contribution to risk at the total fund level, not in isolation. The broader set of investment opportunities that the Russell model portfolio framework covers brings with it the need to take into account a different set of risk considerations. Risk is not simply about asset volatility, but also about liquidity, lock-up periods, leverage, governance, operations, and transparency.

As we work through this process with clients, there are many other implementation issues that need to be addressed, many of which are specific to the particular circumstances of each client. The cost and implementation approach of each potential strategy needs to be considered; many alternative strategies involve higher fees and higher trading costs. Some investments may only trade in less liquid secondary markets prior to maturity. Thought must be given to the demands a strategy places on the organization, and to what the most appropriate vehicles would be. Investors need to be confident that they have the resources and structure to be successful in their execution – with most of these strategies, even more than with traditional investments, it is not enough that they are done, they must be done well.

The end result: better portfolios

Russell's model portfolio framework offers a path by which endowments and foundations can reduce their reliance on equities through broader exposure within public markets, an increased impact from skill-based alpha strategies and more exposure to various types of alternative and opportunistic investments.

¹ The 2007 Yale Endowment annual report.

² NACUBO Endowment Study 2007 – 47% equal weighted allocation to equities for funds greater than \$1 billion; 57% equal weighted; and 47% dollar-weighted allocation to equities for the total participants in the study.

³ 2008 Commonfund Benchmarks Study © for 300 independent/private foundations and community foundations for Fiscal Year 2007.

⁴ Based on Russell Capital Market Forecast Assumptions – 10 Year Return Horizon: January 2008.

⁵ Baldrige, J. (2008) *A wonderful, wide world of investment opportunities*. Presentation to Russell Institutional Summit, March 17-18.

⁶ For a discussion of whether these return aspirations are likely to be met for endowments and foundations in general, see Blackwell, R. and R. Collie (2008) *Q: Will a 6% real return be available to non-profit investors in the future? A: Not always*. Russell Research, April.

For more information:

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