Series: Trends in nonprofit investing

Video 1: How to strengthen your organization’s investment strategy

Kenn Lamson: Hello, I’m Kenn Lamson. I lead Vanguard’s Nonprofit Relationship Management business. I’m here with my colleague, Chris Philips, who leads Vanguard’s Nonprofit Outsource Chief Investment Officer business. Good morning, Chris.

Chris Philips: Good morning, Kenn.

Kenn Lamson: Chris recently wrote a three-part series on Vanguard’s investing approach; how it can strengthen nonprofit endowments; and how our approach is distinctly different from the Yale Endowment Model.

Let’s start here, Chris. I know in the years I worked with nonprofits, I’ve heard this phrase of the Yale Endowment Model time after time. For our viewers’ benefit, let’s level-set a little bit. Talk about what that is.

Chris Philips: Sure. So, the Yale Endowment Model is one that is based on a couple of core principles. One is the idea that an endowment exists in perpetuity. It exists to fund the programs of a university for many years in the future. Because of that, there is a need to take risk in the portfolio to generate returns to meet those spending requirements.

The hallmark, though, of the Yale Model is one of access, and because of that accessing illiquid risk premia, build their porfolio around those four concepts and bring them all together.

Kenn Lamson: So, we’ll come to the four concepts in a minute. Has the approach paid off? What’s the performance been like?

Chris Philips: For Yale, absolutely! So, when you look at a 30-year track record, at over 12% returns per year, that’s a very, very healthy return by any stretch of the imagination.

Kenn Lamson: And I’m guessing the great performance for Yale, maybe other firms too, has spawned some imitators downstream?

Chris Philips: Oh, absolutely. So, when you actually look at the trends in the nonprofit space, we do see this kind of follow-the-leader mentality.

And Yale was the first, quickly followed by other large endowments in the late ’80s, early ’90s. Soon after that, midsized endowments started to increase their exposure to alternatives and, more recently, in the mid- to late-2000s, we see a lot of smaller endowments starting to increase their exposure to alternatives.

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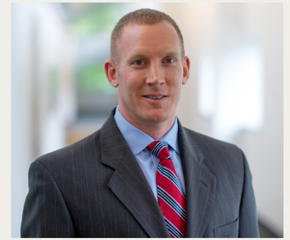

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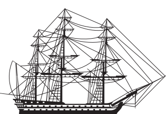

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There are a couple things to note though. There is that high-level trend of increasing exposure to alternatives. But, more notably, we see where those assets are coming from, and it's really been a reduction of fixed income investments that is allowing these endowments to really pursue alternative investments.

Kenn Lamson: Interesting. So, let's talk about the risks a little bit. My guess is that the risk profile of the endowment portfolios [that] are adding these alternatives has meaningfully increased. Can you talk a little bit about what risks are being added there?

Chris Philips: Sure. There are a variety of risks. Most often, what you would hear is that one is going into private equity or VC, venture capital, illiquid credit, etc., for diversification, maybe some alpha-return opportunities.

But what we see is when you actually break down the portfolios and look at where risks are generating returns themselves, we see portfolios that are generally in the 75% or 80% equity-like camp. So, they really are taking on a significant risk profile, but it's not traditional just long-only equity risk. You have liquidity risk. You have insolvency risk. You have the risk of things happening in the portfolio where you can't meet those funding needs. So, there are a lot of other things happening that particularly smaller and midsized endowments really need to pay attention to.

Kenn Lamson: Sounds like it. So, the risks are being added to returns initially were really good. Where are they headed now? What's performance been like over the last 10, 15, 20 years?

Chris Philips: Well, it's interesting. When you look at long-term trends, when you look at rolling ten-year periods, so not short time frames, but rolling ten-year periods, we see two big trends. One is that the level of returns for all endowments has systematically come down when you look at from the '80s, the '90s, to the 2000s, and where we are today.

The second is that there's been a compression of those returns. So smaller endowments, which are generally the lower performing endowments, have started to get closer and closer to the performance of the large endowments. So, the dispersion between the best- and the worst-performing cohorts has shrunk pretty meaningfully from the early ten-year periods to the most recent ten-year periods.

Kenn Lamson: Interesting. So, if risks are increasing and performance is not so great, compression between the best performers and the worst performers, what's your best guess as to why, particularly the smaller endowments, continue to pursue this?

Chris Philips: I think there are a couple of reasons—one I'm very, very sympathetic to. And that is that it's hard to find returns anywhere in markets today, at least on a go-forward basis. You look at expected returns for equities for fixed income. They are lower than we've seen in the past.

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So, if you are an endowment and you are trying to spend 4% or 5% annually, and you're trying to keep your corpus real, adjusted for inflation over time, you need to find returns from someplace, So there's a natural proclivity to look for returns elsewhere.

But there is a follow-the-leader mentality as we showed in the trends over time. And so, the other big thing that I do see is there is a fear of being on the outside looking in.

And this is a behavioral mechanism that we see across investment committees and the portfolio managers within the endowment community where, if all of their peers are doing something, it's extremely difficult to not be doing the same thing.

The last I'd say is hope—hope springs eternal. It hasn't worked out the last 10–15 years, but there's always that hope that it will work out in the future.

Kenn Lamson: Right. In my experience at least, nonprofits, by their very nature, are hopeful folks. I think we can understand that. That's a great spot to leave this one. Thanks for articulating some of those risks and concerns about the Yale Endowment Model.

We'll be back with two more videos in this series. You can check out Chris's blogs on the endowment model at institutional.vanguard.com.

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