Series: Trends in nonprofit investing

Video 2: Why the endowment model has lost its edge

Kenn Lamson: Hi, I'm Kenn Lamson. I lead Vanguard's Nonprofit Relationship Management business and I'm here with Chris Philips, who leads Vanguard's Nonprofit Outsource Chief Investment Officer business. Good morning, Chris.

Chris Philips: Good morning, Kenn.

Kenn Lamson: We're continuing our discussion about the Yale Endowment Model and how Vanguard's approach can help strengthen nonprofits.

Chris, in the first of the video series, we were talking about the Yale Endowment Model, why you're seeing performance wane there. Maybe you can catch us up a little bit. You were talking about a couple of challenges related to the model.

Chris Philips: Yes. So, ultimately, I think they boil down into two big categories. One is, I'm going to steal a phrase from one of my colleagues here at Vanguard; you've probably seen him on other videos, Fran Kinniry; he's in the Investment Strategy Group. He talks a lot about the paradox of skill. I think it is relevant in the world of endowment investing as well. So that's one of the big challenges, and we'll dig in a little bit.

Kenn Lamson: Sure.

Chris Philips: The other is what I kind of refer to as the reality of basic economics. And we can touch on some of that as well.

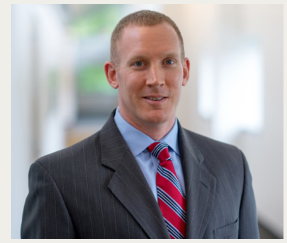
Kenn Lamson: Sure. Well, let's talk about the people element of it first. To me, that's one of the more interesting elements of what we do, and sometimes one of the more intractable ones. Maybe there's an example that you can share with our viewers that highlights that challenge especially.

Chris Philips: Sure. There are actually a couple of examples that I'll share, some trends over time, and then, a very tangible example that, hopefully, the viewers will really be able to understand.

First is, when you think about the skill in the marketplace, we do see skill just increasing systematically year over year. One way that we like to proxy this, it's a very simplistic measure, but just the number of CFA® charterholders.

Kenn Lamson: Sure.

(continued on next page)



Chris Philips,
Principal,
Vanguard Institutional
Advisory Services®

Chris Philips: And you and I are both charterholders, but we see the numbers just exponentially increasing year over year. So, this is an industry that is attracting the best and the brightest out there. And what that means is that when you sit down and you're making a trade in a portfolio, whether you're at Vanguard or someone else in the industry, or trying to do it yourself, you always have to ask the question, who's on the other side of that trade?

Kenn Lamson: Right.

Chris Philips: And this is characterized by a very real example, and we use it in the blog that you reference. There were two quarters back to back a couple of years ago where Warren Buffett and George Soros were both transacting in Apple stock. Now, Buffett was buying, Soros was selling, which is interesting.

Kenn Lamson: Right.

Chris Philips: Because you have two of the most preeminent investors out there in the history of investing on exact opposite sides of a trade. I'm sure they weren't investing with each other. They weren't actually trading with each other, but they each had information that they felt was valuable to their shareholders that led them to those particular transactions. And they were bulls versus bears. And that's the reality of the marketplace we're in today.

This idea of the paradox of skill has a couple of real implications. One is that we do see the dispersion of returns shrinking. And what that means is that there are fewer huge winners and huge losers. You're getting clustered around the median and the median is underperforming the market. This is a very, very real challenge for investors who are trying to outperform—is how do you discern luck versus skill?

Kenn Lamson: Yes. Those are really interesting examples. So let's talk about the second one, the economic challenges that the Yale model is facing.

Chris Philips: Yes. So this isn't economics in the sense of GDP or inflation. This is actually even more simplistic, which is the law of supply and demand. What we see is that the demand for illiquid vehicles is rising from endowments, from foundations, from pension funds, from high-net-worth investors, etc., etc. The supply of these portfolio investments is increasing rapidly as well. So over the last 10 to 15 years, the number of private equity firms has increased about four times.

Kenn Lamson: Wow!

Chris Philips: So just about anyone can go out and hang a shingle and try to invest in start-up companies.

(continued on next page)

The liquid capital that these same firms have available to invest in these portfolio companies is up around five times over the same period. So you see a tremendous amount of liquidity in the marketplace. You see a ton of private-equity firms trying to apply that capital and seek out these portfolio companies. I don't believe that there are four to five times more great opportunities to put that money to work, which is that supply and demand. So there's not a huge supply of good investments.

There is a huge supply of capital trying to chase those, which is going to shrink those returns over time. And we do see that manifesting in the marketplace.

Kenn Lamson: And so do you have a sense of what the endowment, the nonprofit spaces' role in this challenge has been? Are nonprofits driving this whole trend?

Chris Philips: Yes. So, there are a couple surveys out there from third-party providers that show that about 40% to 50% of nonprofits, particularly in the endowment space, are looking to increase their allocations to illiquid investments focused primarily on private equity in order to get, as I referenced in the first segment, that extra liquidity premium that would help drive their expected returns.

Kenn Lamson: And I'm guessing similar challenges in private debt, hedge funds, some of the other illiquid private investment types.

Chris Philips: Absolutely.

Kenn Lamson: Great spot to leave this. Thanks for articulating those challenges, Chris. Really interesting stuff. Thanks for joining us for the second of our three-video series on the Vanguard Endowment Model. Check out Chris's blog at institutional.vanguard.com.

Important information

All investing is subject to risk, including the possible loss of the money you invest. Diversification does not ensure a profit or protect against a loss.

Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in the target-date fund is not guaranteed at any time, including on or after the target date.

Vanguard®

Institutional Investor Group

P.O. Box 2900
Valley Forge, PA 19482-2900

IMNPCP2 112018