Series: Trends in nonprofit investing

Video 3: Vanguard's alternative to alternatives

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 Outsourced Chief Investment Officer business. Good morning, Chris.

Chris Philips: Good morning, Kenn.

Kenn Lamson: We're continuing our discussion of the Yale Endowment Model and Vanguard's answer to that. We've been talking in the first two videos in this series about the Yale Endowment Model, some of the challenges there.

I'd like to start this one, Chris. Given those challenges you've articulated, what should nonprofits be thinking about doing differently?

Chris Philips: Yes, I think for us, really, we focus on four key pillars. And that is understanding the investment philosophy of the endowment, as well as the partner organizations that they work with, focusing on operational scale, thinking deeply about the role of cost, and then understanding how important discipline is in a portfolio. And those four big buckets together we do believe that if an endowment or a foundation really harkens to those, that they will see success over time.

Kenn Lamson: Great. So let's take them one at a time. Let's talk about the philosophy first. How do you guys think about that?

Chris Philips: This is really not just the core philosophy of the investment management firm that the endowment might be partnering with, but it is the philosophy of the endowment themselves. They need to be aligned. And if there is a misalignment, then you're going to see tensions over time. You're going to see potentially return- chasing, bad behaviors, poor discipline; and you see it flow through the other components.

When I think about our philosophy as an investment manager, we very much believe in taking on what we call compensated risks. Alpha is extremely difficult to try and pursue consistently over time. We do believe in maximizing our take of those areas where we do have a reasonable probability of success over time.

Kenn Lamson: Makes sense. So the second one then, operational scale. Define that for us, and tell us how it works at Vanguard.

Chris Philips: Sure. So perhaps talking about Yale for a second might help define this as well.

Kenn Lamson: Yes.

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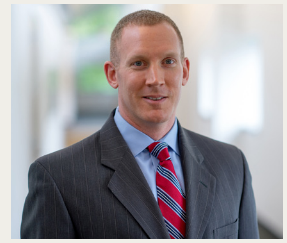

Chris Philips
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Chris Philips: Yale is one of the largest endowments out there. They have scale and they can go and access all of these different opportunities that they might pursue, whether it's research, whether it is pure investments, partnerships, etc. For Vanguard or other endowments, really, the idea of scale is something that they effectively need to outsource.

Kenn Lamson: Understood.

Chris Philips: And why Vanguard? Well, you're a $5 trillion asset manager. That comes with a lot of advantages. We do have a significant in-house investment operation that that scale allows us to continue to refine over time. We have a world-class manager search and oversight function at Vanguard that partners with third-party investment managers to bring best-in-class managers to our end-clients.

We have a world-renowned risk management function here, again, in house. And for an endowment to try and build that themselves, it is a very tall hurdle.

And lastly, we have a global team of economists, investment strategists that help all of our client-facing portfolio owners really talk to what's happening in the marketplace, understand those macro trends that might be taking place, and think deeply about all the different investment options. And you bucket those big four things together, and you come up with this idea of operational scale that not one endowment out there can replicate.

Kenn Lamson: Yes. Sounds pretty compelling. Wouldn't be Vanguard if we didn't talk about cost, though, so let's hear how that works in this equation.

Chris Philips: Yes, so the role of cost is something that you, obviously, would expect to hear from Vanguard.

Kenn Lamson: Naturally.

Chris Philips: It's buoyed by a slew of academic research that shows that cost is the single most important determinant of relative performance. All the studies out there show that higher cost on average underperforms lower cost. So, for an endowment to really focus in on cost, it's critical in our opinion.

Now the trend in the marketplace would suggest something different. And what we do see from some third-party research out there is that costs among nonprofit investors are rising. And investment management fees today are about 70 basis points. That's not advice. That is not the cost of the investment management team. That's just the pure portfolio investments that they're using. It's driven by their allocation to alternatives, as you would probably suspect. But 70 basis points up from close to 50 a couple years ago, that is a significant increase and moving in the opposite direction of what we think would be successful.

Kenn Lamson: Yes, important to consider. What comes to mind is one of my favorite Jack Bogle sayings, "You get what you don't pay for." Makes a lot of sense.

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Let's shift into the fourth pillar that you articulated around discipline. Talk about how you guys instill that in the nonprofits you work with.

Chris Philips: Sure. So, I would actually believe that almost any organization you talk to would say they have a disciplined approach to investing. You wouldn't be credible if you said we were undisciplined.

Kenn Lamson: Naturally.

Chris Philips: So, I think that's important to recognize first, but we take discipline with a slightly different viewpoint. And that is that the sole responsibility of our investment managers that partner with the organizations that are with Vanguard, they exist to prevent humans from doing human things. The investment committees, the treasury staffs that we partner with, they're all people and people do, as I said, people things. And so discipline itself is one of those key components that, again, is buoyed by research. We see time and time again, whether it's individual investors, whether it's financial advisors, whether it is institutional consultants or portfolio managers, they do things like chase returns. They get out of investments right before they're starting to rebound. And the evidence is overwhelming that if you just sit back and do nothing outside of rebalance, or make truly strategic shifts in the portfolio, that you're going to be a detriment to the overall performance.

Kenn Lamson: So accounting for all four of those pillars, Chris, I guess really the key question is how have returns been?

Chris Philips: Yes, that's the ultimate question. So, I can talk in platitudes all day long and no one will listen to me if it doesn't actually pan out on paper.

Kenn Lamson: Exactly.

Chris Philips: So what we do see is that the model that we have here for partnering with our clients has shown to be successful over time. We look at a number of different categories. Whether it is in the foundation world, we'll look at the Council on Foundations reports; in the endowment world, we'll look at the NACUBO analyses and reports, which for this peer group is representative of the typical endowment portfolio.

And we do see that these core models that we have to help characterize performance hold up very, very well relative to those broad peer groups, whether you want to look at individual cohorts within the NACUBO universe or the broad NACUBO universe itself. And somewhat interestingly, this isn't an active or passive conversation. We're not dogmatic that it's one or the other.

We have models that have an active-centric bent and we have models that have a passive-centric bent, and it's the Vanguard model that has shown to be successful relative to these peer groups over time.

Kenn Lamson: And I'm guessing from what I know of your business, you guys do a great job of customizing for each client the mix of active and passive, and you can tilt the portfolio as is needed.

Chris Philips: We do. We have a bespoke model, so it is client by client. We certainly do not use model portfolios. We are going to sit down with an investment committee, with that staff, and really identify what their true needs are, what the biases are of the committee, what other constraints or benefits they might have, how volatile is their donor base over time, for example. And we'll build a portfolio that is suitable to what their specific needs are.

Kenn Lamson: Right. Great to hear. Thanks for recapping the Vanguard Endowment Model. More on this and the first two blogs in our series at institutional.vanguard.com.

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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.

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