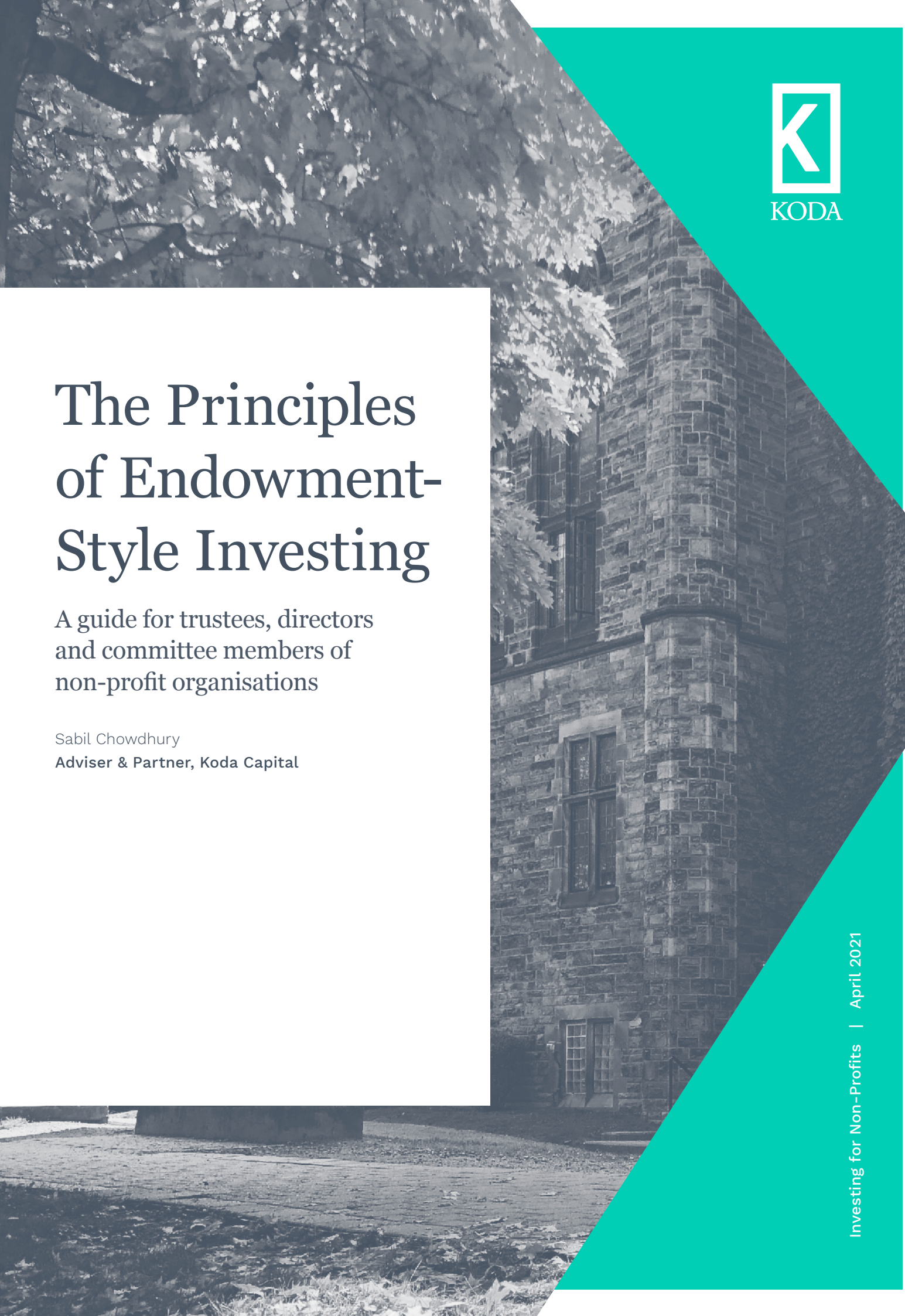

KODA

The Principles of Endowment-Style Investing

A guide for trustees, directors and committee members of non-profit organisations

Sabil Chowdhury
Adviser & Partner, Koda Capital

Investing for Non-Profits | April 2021

“Especially in today’s low-return world, most institutional investors have given up on getting the returns they need from traditional stocks and bonds. Koda Capital’s white paper on Endowment-Style Investing explains why movement into alternative asset classes is indispensable for success in today’s markets.”

Howard Marks Co-founder & Co-chairman of Oaktree Capital Management

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Executive summary

Since COVID-19 started, Koda has seen a significant increase in larger charities and sophisticated non-profit groups reassessing how they manage their cash and reserves. Investment committees who realise they are operating in a new paradigm are re-evaluating their asset allocations and looking for better diversification.

By observing how successful investors such as Yale University and Australia's Future Fund invest, we find that these institutions adopt an endowment-style approach to investing which has helped them generate consistent long-term returns while preserving the capital invested even during market crises such as the GFC and COVID-19.

An endowment-style approach to investing is the solution to managing long-term capital in a world full of uncertainty. This investment approach offers a set of guidelines and principles, validated by renowned university endowments, to help non-profit organisations manage their capital with lower risk and generate more consistent returns.

In this paper we discuss the principles of endowment-style investing and how this approach leads to greater diversification, lower levels of volatility and the increased likelihood of achieving objectives over the long-term.

Introduction

Endowment funds are pools of assets established by non-profit organisations such as universities, religious institutions or hospitals, intended to be invested over a long period of time and generate returns used to fund regular withdrawals from their invested capital.

Many well managed non-profit organisations adopt a distinct approach to investing known as 'endowment-style investing'. This investment approach focuses on achieving superior results through exposure to alternative, private and illiquid investments. However, the Australian non-profit sector has been traditionally overweight in cash and property assets[1].

According to ABS's most recent survey, Australian non-profits held 19% of their assets in cash, 66% in property and 7% with investment managers. It is challenging for non-profits to generate strong returns given their overweight exposure to cash and property assets, especially in such a low interest rate environment and with very low property rental yields.

There is a better way to manage capital by adopting an endowment-style approach which aims to generate consistent long-term returns through diversification into non-traditional asset classes. In this paper we discuss the origins and principles of endowment-style investing and share lessons learnt from successful university endowments.

[1] Australian Bureau of Statistics (2013) Non-Profit Institutions Satellite Accounts

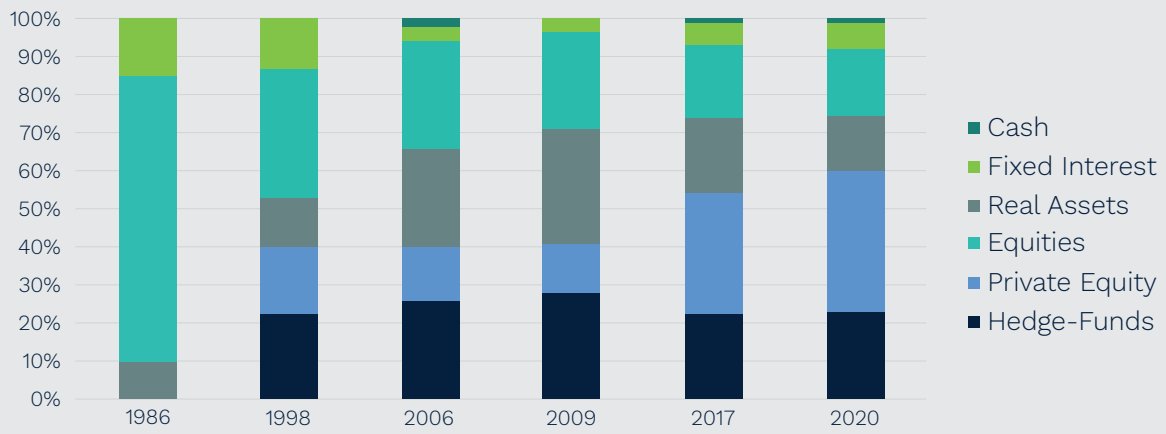
Origins of Endowment-Style Investing

In 1952, Nobel Prize Laureate Harry Markowitz published his influential paper "Portfolio Selection" which set the groundwork for Modern Portfolio Theory (MPT)[2]. Markowitz showed that risk-adjusted returns can be maximised by diversifying across various asset classes. The MPT investment philosophy was widely adapted by university endowment funds such as Harvard and Yale.

Gary Brinson, Randolph Hood and Gilbert Beebower (1986) published their paper "Determinants of Portfolio Performance" which added further evidence that superior diversification improves long-term returns (with respect to risk). The researchers collected data from 91 large U.S. pension funds from 1974 to 1983 and found that over 90% of the time, superior investment performance was attributed to having a strategic asset allocation and effective investment policy in place[3]. For more information please read Koda's publication on writing an effective investment policy statement using this link[4].

These findings influenced large universities such as Yale to further diversify their endowment funds by reallocating capital taken from traditional assets such as equities and bonds, to alternative investments such as private equity and hedge-funds. The following chart shows the Yale endowment fund's gradual increase to alternative assets.

Exhibit 1. Yale's gradual allocation to alternatives



Source: Randy Brown (2020) SLC Management. Published on Forbes 3rd November 2020.

David Swensen, the Chief Investment Officer of Yale's endowment fund, influenced other universities such as Harvard and Stanford to diversify their endowments away from public markets to private markets. Yale has managed one of the most successful endowment funds with net returns over 12% p.a. since the mid-1980s[5] and Swensen pioneered the 'Yale model' which is now considered standard practice in endowment fund investing.

[2] Harry Markowitz (1952) Portfolio Selection, Journal of Finance

[3] Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower (1986) Determinants of Portfolio Performance, The Financial Analysts Journal

[4] Simon Duckett (2016) Investing for Non-Profits An Effective Investment Policy Statement, Koda Capital

What Makes Endowment Investing Different

In this section of the paper we explore the unique characteristics that make endowment-style investing different to the traditional investment approach adopted by private investors. We also discuss the drivers that lead to the superior risk-adjusted returns from endowment-style investing.

1. Having a long-term investment horizon

Endowment funds are typically structured so that the principal invested is preserved in real terms while a portion of the returns is available for funding the organisation's ongoing cash-flow requirements. Most endowment funds hold the principal over the very long-term and many intend to do so in perpetuity. This long-term investment period is one of the key characteristics that make endowments different to private investors since endowments can tolerate illiquidity and may not need immediate access to their capital invested.

Illiquidity premia refers to the additional yield demanded by investors when any given investment cannot be easily converted into cash for its fair value. Due to their long-term investment horizons, endowment funds can take on illiquidity premia to enhance returns while other investors may not have this option given their limited investment timeframes and liquidity constraints.

2. Taking advantage of buying opportunities

Given their long-term investment timeframes, endowment funds can take advantage of buying opportunities during market crises and corrections as they expect prices and valuations to recover over market cycles.

In the recent publication "Seventy-five years of investing for future generations" David Chambers, Elroy Dimson and Charikleia Kaffe analysed data on 12 university endowment funds from 1900 to 2017[6].

The researchers found that top-performing endowments such as those at Princeton, Yale and University of Chicago increased allocations to growth assets during market crises and this led to the endowments achieving higher risk-adjusted returns than traditional benchmarks over the long-term. Risk-adjusted returns are measured by the Sharpe Ratio which is calculated by dividing a portfolio's excess return over the risk-free rate by the standard deviation (which is a measure of a portfolio's volatility). The outperformance of the risk-adjusted returns of the top-performing endowment funds relative to a benchmark portfolio is summarised in the table below.

Exhibit 2. Endowment Fund Performance and Risk

	Annualised Return	Standard Deviation	Sharpe Ratio
Princeton	7.9%	12.8%	0.64
Yale	7.8%	13.0%	0.62
Chicago	7.3%	14.0%	0.54
Benchmark Portfolio	5.6%	14.9%	0.37

Source: Chambers, Dimson, Kaffe (2020) "Seventy five years of investing for future generations" Financial Analysts 2020, SLC Management.

[5] Yale Investment Office website, accessed on 25.01.2021, URL

[6] David Chambers, Elroy Dimson, Charikleia Kaffe (2020) "Seventy five years of investing for future generations" Financial Analysts 2020, SLC Management

3. Superior diversification through alternative investments

According to Modern Portfolio Theory, a diversified portfolio with exposure to uncorrelated asset classes will have lower volatility and generate consistent returns over the long-term. Allocating to alternative investments is a strategy adopted by endowments to diversify exposure from traditional investments to maximise their risk-adjusted returns.

Alternative investments do not fall into one of the traditional asset class categories such as equities or bonds and can include private equity, real assets (including direct infrastructure and commercial property), hedge-funds and commodities. Alternative investments are generally less correlated to traditional asset classes, meaning that the price movements of alternatives do not closely follow the same trend or direction as traditional assets.

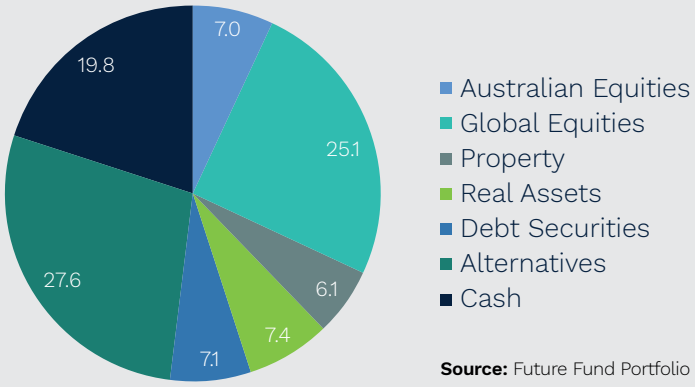
The low correlation between alternative and traditional investments reduces the overall volatility of portfolios. As a result, diversified portfolios with exposure to alternatives can better withstand market corrections and minimise the risk of portfolio drawdowns (which are the peak-to-trough declines during specific periods for a portfolio). This helps preserve the capital invested over the long-term.

Most alternative investments are unlisted such as private equity, private debt and infrastructure assets. Since the prices of these assets are not updated frequently (unlike listed securities) the volatility of a portfolio holding these assets is reduced.

This is a key reason why unlisted alternative investments have better Sharpe ratios than listed securities. The lower volatility may seem illusory, however dampening the quantum of a portfolio's fluctuations provides comfort to investors who may have otherwise reacted irrationally to frequent portfolio movements.

Endowment-style investing has also been adopted by sovereign wealth funds such as Australia's $171 billion Future Fund. The Future Fund's allocation to alternative investments has been one of the key drivers that helped generate strong average returns of 9.0% p.a. over a 10-year track record (as at 31 December 2020), outperforming its benchmark target by 3.8% p.a.[7] See the Future Fund's asset allocation chart below.

Exhibit 3. The Future Fund's Asset Allocation



Source: Future Fund Portfolio update at 31 December 2020.

Koda's endowment-style investment approach involves building highly diversified multi-asset portfolios with exposure to investments that have minimal correlation with one another. This approach allows our non-profit clients to remain substantially invested throughout market cycles whilst generating strong risk-adjusted returns that support their mission and objectives.

[7] Future Fund Portfolio Update December 2020, Accessed on 21.03.2021, URL

4. Selecting the right investment managers

The decision to diversify into alternative assets will not in itself improve results. Selecting skilful investment managers plays a critical part in achieving superior returns relative to a benchmark portfolio.

Although some less-efficient asset classes offer the possibility of finding mispriced assets, investing in a less-efficient asset class does not necessarily lead to achieving superior returns.

The investment manager still has to have the skills required to identify mispricings, and the investors and their advisers have to have the ability required to pick superior managers.

Successful manager selection played a significant part in David Swensen's successful track-record and is also a key investment belief held by the Future Fund[8].

> "Markets can be inefficient to an extent that skilful management can add value after fees. Such 'net alpha', being uncorrelated with other return streams, is extremely valuable to the total portfolio"

Source: Future Fund Investment Beliefs

5. Access to specialist managers to generate alpha

Given their large scale, endowment funds have access to specialist investments that are not commonly accessible to private investors. Often specialist fund managers limit their capacity to institutional investors with large investable amounts. Access to specialist managers can help endowments generate "alpha" and returns higher than a benchmark portfolio.

Sources of alpha can include access to specialised investments such as infrastructure, private equity, private debt and impact investments. These sources of alpha which are carefully vetted by research teams and advisers can help endowments achieve superior risk-adjusted returns uncorrelated to traditional asset classes.

Access to superior investment opportunities is essential to achieving superior risk-adjusted returns. This access is often restricted to investors that have a long history and relationship with fund managers.

At Koda, we have built long-term relationships with specialist managers that have demonstrated a consistent track record of alpha generation.

[8] Future Fund's Investment Beliefs, Accessed on 25.01.2021, URL

Conclusion

Investing successfully on behalf of a non-profit is a challenge that comes with significant responsibility. Non-profit organisations serve a purpose or mission that is often multi-generational and therefore their portfolios should be invested in a way that is designed to last for several generations.

By observing how renowned investors like Yale and the Future Fund manage their investment portfolios, we find that the best way to preserve and grow long-term capital is by adopting an endowment-style investment approach.

An endowment-style approach offers a set of guidelines and principles for non-profit organisations to help them remain substantially invested throughout market cycles, minimise market volatility and generate consistent returns to meet their objectives.

Implemented correctly, endowment-style investing can help non-profits achieve enormous success for their mission, be that educating generations of students, funding medical research or supporting social programs.

How Koda Helps Implement Endowment-Style Portfolios

Koda was founded to serve private clients whose assets are multi-generational and charitable institutions that have endowment-style funds. An endowment-style investment approach is core to Koda's investment philosophy, and this differentiates us from our peers.

Our investment philosophy encompasses prudent investment principles and provides a set of core beliefs that guide our investment process and advice. These beliefs revolve around protecting our clients' capital and reducing the volatility of their returns to provide a more stable and reliable investment journey.

Koda can help your non-profit organisation transition from a traditional investment portfolio to an endowment-style portfolio by looking to review and update your investment policy statement, investment mandate, governance policies and implement an endowment-style portfolio designed to preserve and grow capital over multiple generations.

We hope that you found this white paper valuable and welcome the opportunity to discuss how we may be able to assist you or your organisation.

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Sabil Chowdhury
Partner | Investment Adviser to Non-Profits
Koda Capital

Sabil is a Partner and Investment Adviser at Koda Capital and has worked in financial services since the mid-2000s. Sabil specialises in supporting non-profit organisations with their investment management.

His specialisations include providing advice on customised investment mandates, strategic/tactical asset allocation, alternative investments, financial modelling, risk management, governance and compliance for non-profit organisations.

Before joining Koda, Sabil was a Private Wealth Adviser at Macquarie Private Bank, providing holistic wealth management and investment advice to executives, family offices, and non-profit organisations. Prior to that he had advisory roles at Perpetual Private Wealth and KPMG Risk Advisory.

Sabil holds a Bachelor of Mathematics from the University of New South Wales, Master of Management (Graduated with Distinction) from the University of Sydney Business School and Diploma of Financial Planning (RG146) from Kaplan including accreditations in SMSF, Gearing/Lending and ASX Derivatives Levels I and II. Sabil was also Financial Standard's Power50 ranked adviser in 2020.

Contact

E sabil.chowdhury@kodacapital.com

M +61 438 668 768 | T +61 2 8651 3458

kodacapital.com

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