PART I

In Defense of the Endowment Model, Rightly Understood

The "Endowment Model," we're told, is under pressure. For our country's endowed civic institutions, it's allegedly too complex, illiquid, and costly. One of the loudest detractors recently reflected on the track records of even the largest endowments, writing that "there is no sign of exceptionalism in the performance figures."[1] With self-assured finality, he declared, "the endowment model is dead as a door nail."[2]

But while that sort of pronouncement makes for good copy, it's overstated and misses the point. From what I've observed in my career deploying capital for endowments, foundations, families, and other long-term investors, reports of the "death" of the Endowment Model have always been greatly exaggerated. Instead, when properly understood, assessed, and executed, endowment-style investing looks a lot like any other form of active management, with the same attendant virtues and tradeoffs. **Superior risk-adjusted returns were never guaranteed to all comers, but we believe they will continue to accrue over time to the most capable investment offices.**

The Long View

from the desk of Matt Bank
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GEM

Arguments against the Endowment Model typically make at least one of three critical errors:

- **First**, a misconception that it's a "model" at all. Choosing that word wrongly implies that there is some step-by-step recipe to follow—a prescriptive and static way to construct a portfolio that is consistently applied across institutional pools of capital.

- **Second**, an unreasonable expectation that the validity of the approach hinges on its efficacy in all market regimes and over all time periods.

- **Third**, a fallacy of composition—that its apparent failings for some is a sign of its failings for all.

Each one reflects a misunderstanding of what endowments are trying to accomplish and how they're trying to accomplish it. In future writings, we'll take the time to review and unpack some of these issues: why, for example, the quantitative arguments against endowment results aren't as clear-cut as critics make out, or what successful endowment stewardship entails, especially the organizational and cultural prerequisites.

But for now, let's tackle a more fundamental question:

What is (and isn't) the Endowment Model?

It may seem a simplistic place to start given the term's prevalence, but it's necessary. The framework pioneered by Yale's longtime Chief Investment Officer David Swensen unintentionally birthed a sect of literalists, and we need to distinguish the convention from the intention.

Disassembly

For the sake of simplicity, we'll use the term "Endowment Model," much as it pains us to do so. Models are for instruction manuals and blueprints—the types of systems that rely on straightforward replicability. That does not at all describe successful investing.

So, how should one properly conceive of an Endowment Model?

Think of it as a set of principles that align well-framed investment objectives with specific skills and organizational resources. Swensen himself emphasized a few philosophical points:[3]

- **Equity bias**, owing to the perpetual nature of endowed assets and equity's long history as the highest returning asset class;
- **Diversification** to control portfolio volatility, stretching into a broad collection of opportunity sets and less efficient, under-capitalized corners of markets;
- **Careful selection of third-party managers** with durable advantages in their areas of expertise and, importantly, with aligned incentives to maintain an appropriate focus on returns and client partnership; and
- Cultivation of the right **organizational inputs**, among them appropriate scale, a sophisticated and collaborative team culture, deep networks and diligence capabilities, and healthy governance.

Practically every other heuristic that has come to stand in as synonymous with the Endowment Model—the heavy use of alternative strategies, high allocation to private investments, the emphasis on smaller or emerging managers unburdened by excessive AUM, a preference for concentrated portfolios delivering high active share—should be thought of as an output, not an input; in other words, a plausible expression of those tenets but not the tenets themselves.

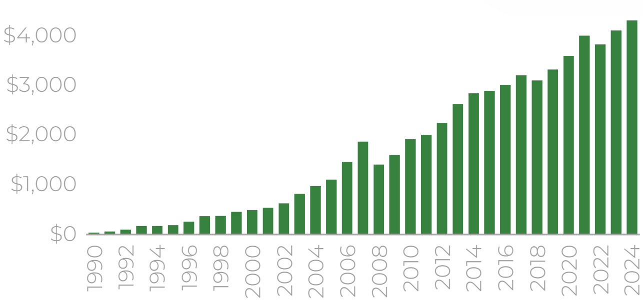
The model is not a paint-by-numbers exercise in asset allocation or manager selection. The strategies successfully employed at scale by Yale and others, including GEM—buyouts, venture capital, hedge funds, real estate—are outputs of deep, manager-centric due diligence and the pursuit of compelling opportunity. We don't use those strategies in an effort to bend the efficient frontier and improve our asset allocation model. There's virtually nothing about most alternative strategies that is fundamentally diversifying. We use them as extensions of our investment opportunity set. In other words, they are ponds to be fished in, not buckets to be filled. Thoughtful allocators long ago stopped thinking of "alternatives" as asset classes at all, recognizing that they're simply conventional market risks repackaged to enable a pursuit of alpha.

Nor is the model right for everyone. It best serves a specific set of perpetual investors who look to preserve or grow inflation-adjusted resources (net of draws) to fund annual operations, scholarships, programmatic goals, or other predictable and recurring liabilities. Those investors must bring to the dance the right skills, risk tolerance, reputation, and governance to capture the benefits of manager dispersion through rigorous selection. Nowhere did Swensen ever suggest that his approach should be adopted by a wide swath of investors with vastly different goals, constraints, scale, networks, and capabilities. In fact, his later writing conceded as much, probably in an effort to stem what he saw as unproductive mimicry from those lacking Yale's execution advantages.

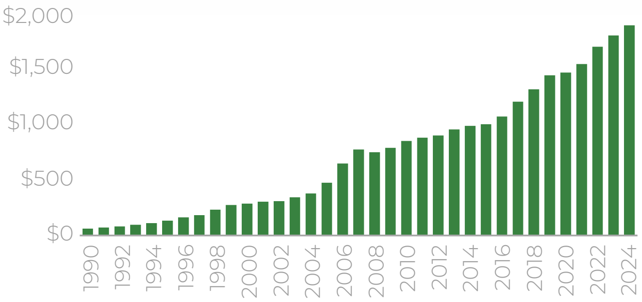
Remodeling

There is, and always has been, a need for novel and forward thinking. In the 1980s and 1990s, international investing was less prevalent. Nearly the entire universe of investable hedge funds could fit on the front and back of a single sheet of paper. The "leveraged buyout" was still emerging. Venture capital was a Silicon Valley cottage industry. Capital has poured—flooded—into all of these segments over time, fundamentally changing their properties and attractiveness for the average investor.

Hedge Fund Industry AUM ($B)[4]



U.S. Buyout Industry AUM ($B)[5]



The goals and principles remain the same, but the conditions have changed, so what have the best endowment offices done? They've adapted. Private commodity allocations, which were robust in the mid-2000s, came down as the super-cycle waned post-GFC. Buyout and venture capital commitments grew as portfolios matured, but have evolved in their complexion. Other absolute return strategies and alternative betas emerged (e.g., reinsurance, royalty streams, etc.), providing new arenas for seeking less correlated return streams. Public equity strategies at endowment offices have morphed as well in light of the sustained dominance of the largest, US-based technology firms, especially through and after the factor rotations of 2022.

Strategies have also become more targeted. Those shaking their fists at the sky about "too much in alternatives!" fail to acknowledge that institutionalization of those strategies has led to more nuance. Just as knowing that an institution has 10% in hedge funds tells you nothing about (a) what they own or (b) how it might do, the industry has wrung the utility out of labels. The idea that (1) a portfolio of lower middle market buyout sponsors pursuing buy-and-build strategies across high-recurring revenue services sectors is functionally equivalent to (2) a generalist mega cap private equity fund is clearly wrong. The idea that (1) real estate holdings in stabilized, core assets in a major metro area are the same as (2) hyperscale data center development projects is also wrong. To broadly claim that for all of these allocations, the exposure to equity markets, interest rates, credit conditions, or a dozen other factors is the same misses the important evolutions in endowment portfolios.

Moreover, the endowment community has become more heterogeneous with important distinctions in how even similarly large endowments implement their preferences. The offices at Notre Dame, Duke, Yale, Harvard, and others pursue their endowment programs in very different ways—a diversity grounded in factors like team philosophy, history, governance, and university operations.

That fact is observable in the dispersion of results over time, divergent asset allocation taxonomies, and the rosters of managers utilized. Are there some common practices? Sure, undoubtedly. But the idea that these pools of capital are facsimiles of one another is flawed. More broadly, average allocations and portfolio complexity vary considerably across the endowment landscape, as is appropriate.

A Sturdy Foundation

Endowment-style investing appears complex, but is, in fact, rooted in a straightforward set of underlying principles, which are just as well-considered and relevant today. We're unmoved by the naysayers, who seem to confuse the outputs of endowment portfolios for modellable inputs.

> **Balancing your portfolio for your specific return goals, risk tolerance, and time horizon, and then implementing in a manner that leverages your intrinsic advantages across available opportunity sets, is the Endowment Model.**

It's also, for what it's worth, the Norway Model, the Canadian Model, or a traditional 60/40 stock/bond model. The only difference is who is at the helm. **In the right hands, for the right institutions, endowment-style investing is a compelling means of achieving risk-adjusted returns**—one that enables institutions with enduring purpose to support their multi-generational obligations. But like any approach to active investing, it is not reducible to a recipe book.

In reference to third-party managers and the importance of building conviction, Swensen warned in his first book that **"casual commitments invite casual reversal."**[3] The same applies to any institution's investment framework. It's not enough to draw an asset allocation pie chart as others have drawn it. You must rightly understand why it was drawn that way, how you expect to win, and how to align your team, resources, and stakeholders with that approach for the long run.

Matt Bank
Co-CIO, GEM

PART II

In Defense of the Endowment Model, Accurately Assessed

In Part II of this three-part series, we will tackle the incomplete quantitative arguments around endowment performance and present a framework for evaluating long-term success.

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ENDNOTES

[1] Richard M. Ennis, Unexceptional Endowment Performance, April 7, 2024.

[2] Richard M. Ennis, The Endowment Model Defense That Wasn't, March 17, 2022.

[3] David F. Swensen, Pioneering Portfolio Management, 2000.

[4] Hedge Fund Industry AUM was sourced from Hedge Fund Research, Inc. 2024 data point is as of June 30, 2024.

[5] U.S. Buyout Industry AUM was sourced from Pitchbook, National Venture Capital Association (NVCA), and Morgan Stanley. 2024 data point is as of June 30, 2024.

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