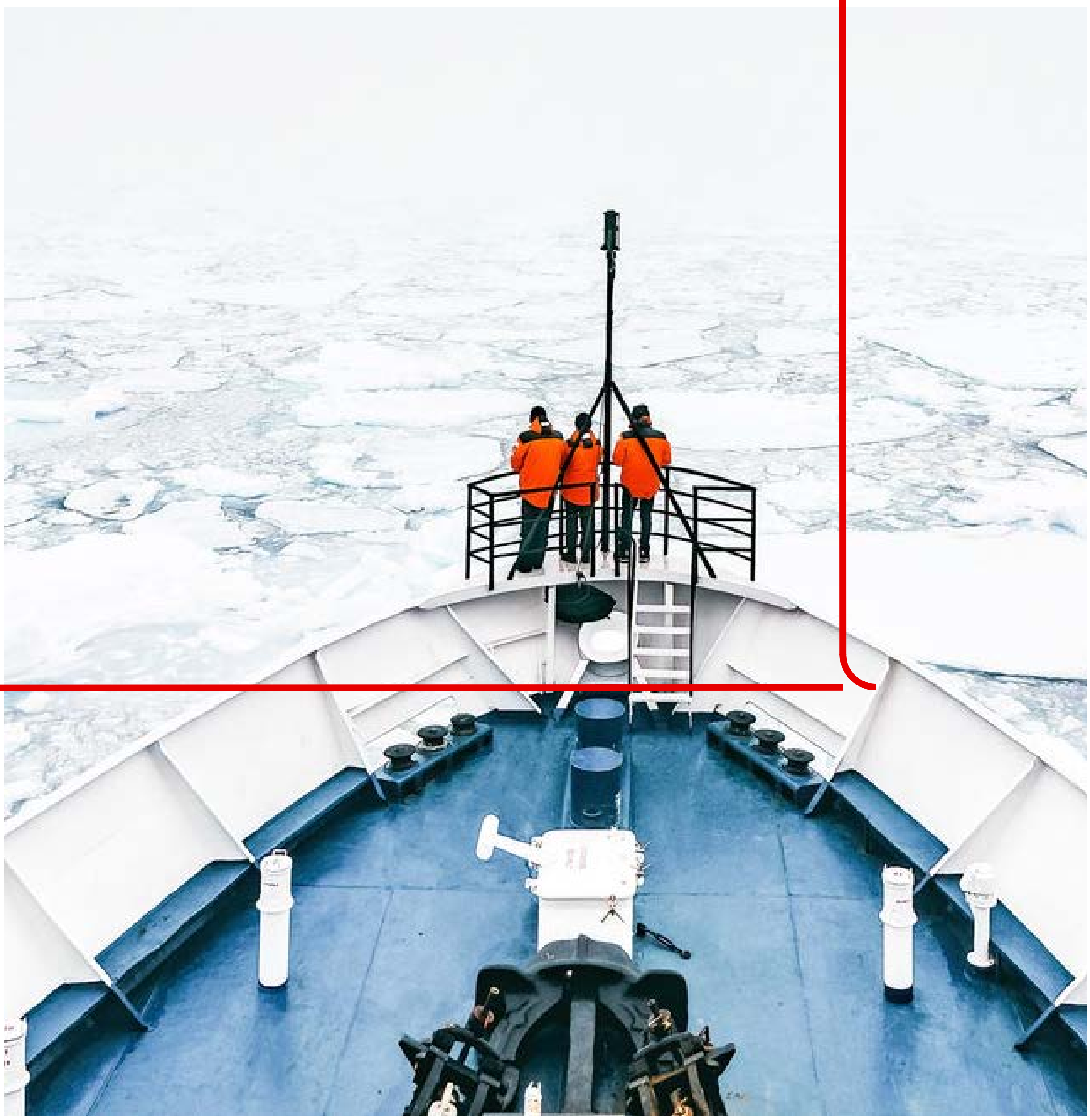
UBS

Endowment Investing

It's about the long-term.



Endowment investing is a method of investing which is increasingly used by charities with a perpetual time horizon. It's aim is to provide recurring income for operational / expenditure needs while preserving the inflation-adjusted value of the assets. The ability to invest not only in liquid assets but also long-term in private markets significantly expands the universe of instruments, exposures and sources of return available to charities.

So what is an endowment investing approach?

In essence, it's investing in a way which aims to meet the needs of beneficiaries over multiple generations and adhere to principles of intergenerational equity. This is through well-diversified portfolios that benefit from higher return potential than traditional asset allocations because they are partly invested in alternative investments. Due to the lower liquidity of these asset classes they tend to offer higher returns.

When clients look to adopt an approach along these lines the asset allocation will shift to having an allocation of 20%+ to alternatives, although the precise allocation will vary according to each client's particular requirements.

By broadening the asset class universe, endowment style portfolios harvest not only the returns that exposure to public markets can capture, but also premiums specific to alternative investments such as private markets and hedge funds. The endowment-style approach is for investors seeking ongoing cash flow or growth while preserving the inflation-adjusted value of their capital, but investors must be willing and able to stay invested over the long term.

This highlights the key similarity between the broader charitable meaning of endowment and the investment meaning: it's about the long-term.

The word "endowment" has a specific meaning for charities, particularly when we're talking about a "permanent endowment" which is money or property that was originally meant to be held by a charity forever. In the context of your financial assets, however, an endowment approach means something slightly different but with one key similarity: a long-term investment horizon.

Many of our charity clients have been around for decades or centuries and therefore have long investment time horizons. I was recently discussing investing with one of my clients. He commented that when he thinks about the investment approach which the college adopts, his overriding consideration is "what will the next but one bursar think of the decisions I make today?".

This is the same for many of our clients. When it comes to how this time horizon is expressed in their portfolios, however, some are highly liquid, with the mainstay of their portfolios being cash, listed fixed income and listed equities.

There are often good reasons for this approach: there is a preference for liquid solutions where there is a chance that the portfolio may need be liquidated to finance capital projects or other significant one-off expenses. In addition it gives flexibility to move managers.

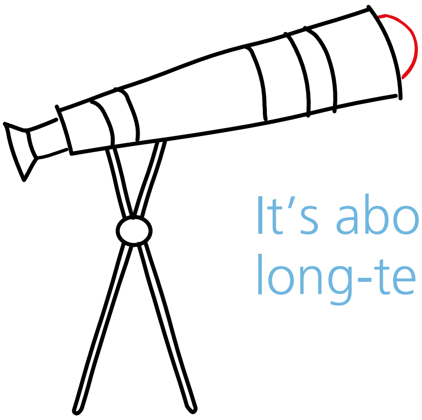
However, the principal disadvantage with the approach is that it leaves money on the table. Our research shows that around 80% of returns are generated by your approach to asset allocation. If you've excluded the (historically) better performing asset classes such as private markets, you're reducing your potential investment returns and therefore the amount of cash which you would have available for the charity in the future. You're also missing out on the benefits of a greater level of diversification in your investments. If you are willing to go down the route of an endowment investing approach you gain exposure to sectors of the market, such as private equity and private credit, which cannot be accessed through the liquid markets.

The historical perspective

Traditionally, we've seen more endowment style investing in the US, particularly in relation to universities but also for museums and hospitals. In the UK, more recently, a number of the larger charities have gone down this route, including the Church Commissioners, the Wellcome Trust, and the central university endowments of Oxford and Cambridge.

On both sides of the Atlantic, over time, what we've seen is considerable changes in the make up of portfolios. If we look back over the history of endowment investing we can see two major shifts. The first was from bonds to stocks in the 1930s and 1940s while the second was from stocks to alternative assets in the 1980s.

The shift to alternatives and private markets in particular is one of the key facets of this approach. Private equity has generated stronger risk-adjusted returns than global equities, global bonds and other asset classes over the past 15 years. In fact, between 2001 and 2016 private equity outperformed global bonds and global equities by approximately 6% per annum, which represents a healthy premium from the asset class. It's because of this outperformance of the asset class that endowment investing is a compelling approach for many of our clients.



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How can clients look to adopt this approach?

One of the key barriers to adopting an endowment approach has been scale and access: for all but the largest charities it has traditionally been difficult to access the higher quality managers. This is really important as there is a wide dispersion of returns in private markets in particular between the better performing managers and those who are laggards. Given that the fees associated with the asset class are higher than those in the public markets any underperformance can really sting – not only are you locking up your cash but you're also spending a significant sum for the dubious privilege of doing so if you're not generating outperformance above public market returns.

The key with getting the approach right if you're going to invest in illiquid assets is to build out your alternatives allocation on a portfolio basis in the same as you would for your liquid assets.

You wouldn't invest in only one share in the public markets so it doesn't make sense to do this in private markets either. Diversification should be on the basis of a number of factors: geography, manager style and, importantly, vintage year. Vintage year is the year in which you make your commitment to a fund and it's this last point which is arguably the most important – vintage years immediately prior to a recession, understandably, tend to underperform. As such the most successful allocations to private markets have been those where our clients have built-out their allocation over a number of years.

The second key point is to be selective in the managers with which you invest, and this is where access is critical.

At UBS we've been allocating assets to private markets for several decades and have built strong relationships with top quality managers. We look to provide investment opportunities to clients which are diversified so that they can build out their portfolios along the lines I just mentioned. We also have a strong track record in terms of manager selection, where 82% of the funds to which our clients have allocated capital have had above median performance for private markets managers.

We've helped many of our clients successfully adopt this strategy by working out a roadmap of how they start their endowment investing journey and how this will help them to meet their long-term aims. As with all investing, it's helping our clients to meet their long-term aims which is the driver of what we do.

Should you consider endowment investing?

Many of our clients already invest along these lines, but if you are considering whether this might be appropriate for your charity, here are three key questions to ask yourself:

- Is there a reasonable likelihood that the charity will exist in 20 years' time?
- Is there any reason why we can't invest part of our portfolio in assets with less liquidity (a reason not to do this might be the knowledge that you will need to liquidate the portfolio in full at some point in the next decade)?
- How will our investment committee in 20 years' time reflect on the decisions we make today?

To discuss how an endowment investing approach can help you please contact your client adviser or Tom Dupernex, Head of Charities UK.

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